



Decision \_\_\_\_\_

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

In the Matter of the Application of California-American Water Company (U 210 W) for an order authorizing it to increase its rates for water service in its Monterey District to increase revenues by \$9,456,100 or 32.88% in the year 2006; \$1,894,100 or 4.95% in the year 2007; and \$1,574,600 or 3.92% in the year 2008; and for an order authorizing sixteen Special Requests with revenue requirements of \$3,815,900 in the year 2006, \$5,622,300 in the year 2007, and \$8,720,500 in the year 2008; the total increase in rates for water service combined with the sixteen Special Requests could increase revenues by \$13,272,000 or 46.16% in the year 2006; \$7,516,400 or 17.86% in the year 2007; and \$10,295,100 or 20.73% in the year 2008.

Application 05-02-012  
 (Filed February 16, 2005)

In the Matter of the Application of California-American Water Company (U 210 W) for Authorization to Increase its Rates for Water Service in its Felton District to increase revenues by \$796,400 or 105.2% in the year 2006; \$53,600 or 3.44% in the year 2007; and \$16,600 or 1.03% in the year 2008; and for an order authorizing two Special Requests.

Application 05-02-013  
 (Filed February 16, 2005)

**OPINION RESOLVING GENERAL RATE CASES**

**TABLE OF CONTENTS**

<b>Title</b>	<b>Page</b>
OPINION RESOLVING GENERAL RATE CASE .....	2
I. Summary .....	2
II. Background.....	3
III. Issues Included in the Settlement Agreements Between Cal-Am and DRA .....	8
IV. Monterey District Application.....	9
A. Contested Settlement Issues .....	9
1. Cost of Capital.....	9
2. Unaccounted for Water Percentages .....	18
3. Meter Replacements .....	19
4. Carmel Valley Main Segments 4, 5, 6, and 10 .....	20
5. Bishop Treatment Plant .....	20
6. Special Request 4 – Establishment of a Water Revenue Adjustment Mechanism (WRAM) Account to Track Emergency Rate Overcollections.....	22
7. Special Request 5 – Endangered Species Act (ESA) Memorandum Account .....	24
8. Special Request 7 – MPWMD Special Conservation Surcharge .....	24
9. Special Request 16 – Balancing Accounts .....	25
B. Uncontested Settlement Issues.....	26
1. Customer Sales and Revenues.....	26
2. Operations and Maintenance (O&M) Expenses .....	26
3. Administrative and General (A&G) Expenses.....	27
4. Taxes and Net-to-Gross Multiplier .....	29
5. Utility Plant in Service .....	29
6. Depreciation Expense and Reserves .....	30
7. Ratebase Including GO Allocation.....	31
8. Customer Service and Conservation .....	31
9. Uncontested Special Requests .....	34
10. Step Rate Increases .....	36
C. Action on Proposed Monterey Settlement .....	37
D. Monterey Issues Not Addressed in the Settlement.....	38
1. Recovery of Costs Associated With San Clemente Dam .....	38
2. Special Request 1: Carmel River Dam .....	43

3. Inclusion of ESA Fines in Special Request 5 .....	55
4. Special Request 8 – Memorandum Account for SWRCB Fines ....	56
5. Special Request 13 – Rate Design .....	59
V. Felton District Application .....	64
A. Contested Settlement Issues .....	64
1. Cost of Capital.....	64
2. O&M Expenses, A&G Expenses, and GO Allocation .....	66
3. Taxes Other Than Income .....	72
4. Income Taxes .....	72
5. Utility Plant in Service .....	73
6. Depreciation Expense and Reserve.....	76
7. Rate Base .....	76
8. Customer Service and Conservation .....	76
B. Action on Proposed Felton District Settlement .....	78
C. Issues Not Addressed in Proposed Settlement.....	78
1. Rate design .....	78
2. Low-Income Program .....	80
3. On-going Municipalization Efforts.....	81
4. Rate Shock.....	83
VI. General Office Rate Case .....	84
A. Salaries .....	85
B. Employee Expense .....	86
C. Outside Services .....	87
D. Amortization of Citizens’ Acquisition Premium.....	87
E. Action on Proposed GO Settlement .....	92
VII. True-Up of Interim Rates Adopted in D.05-12-024.....	92
VIII. Preparation of Rate Tables and Comments on Proposed Decision.....	93
IX. Assignment of Proceeding .....	94
Findings of Fact.....	94
Conclusions of Law .....	101
ORDER .....	102

**OPINION RESOLVING GENERAL RATE CASE****I. Summary**

This decision resolves the general rate case (GRC) applications of California-American Water Company (Cal-Am) for the Monterey and Felton districts and adopts rates for test years 2006 and 2007 and attrition year 2008. Pursuant to Decision (D.) 05-12-024, the two districts have been on interim rates since January 1, 2006. With our adoption of final rates today, these interim rates will be trued-up and a surcharge amount established to collect the balance over the coming 12 months.

Partial settlements for the Monterey and Felton districts and corporate General Office (GO) rate case were filed by Cal-Am and the Division of Ratepayer Advocates (DRA). The settlements were contested by the Monterey Peninsula Water Management District (MPWMD) and the Felton Friends of Locally Owned Water (Felton FLOW). We do not approve any of the three settlements.

Specifically, for the Monterey proposed settlement, we do not find reasonable the proposed capital structure, the cost of debt, the amount allocated for meter replacements, and the request for early discontinuance of recording merger savings (Special Request 14). For the Felton proposed settlement, we do not find reasonable the amount proposed for the Highway 9 project and general and administrative expenses; we also adopt an adjustment for lobbying activities by employees. For GO expenses, we make several downward adjustments to the amounts allocated to Monterey and Felton and also require a showing of reasonableness for total expense increases that are higher than inflation in each

upcoming GRC.<sup>1</sup> We find for both Monterey and Felton that there are several areas, particularly regarding tracking and monitoring customer service and justification for expense items, where further information must be collected and analyzed prior to the next GRC.

For Monterey district issues outside the proposed settlement, we allow recovery of Carmel River Dam expenses, without interest, over a six-year period. We move all San Clemente Dam retrofit costs to a memorandum account. We adopt memorandum accounts for compliance costs but not for fines, and we retain the existing rate design structure.

For Felton district issues outside the proposed settlement, we retain the existing rate design, adopt DRA's proposal for a low-income program, and adopt a rate increase cap of 50% for the next 12 months.<sup>2</sup> We recognize that a formal process for public acquisition of the district has started with the passage in July 2006 of Measure W. We commit to vigilantly overseeing future plant investment in the Felton district as the acquisition goes forward and we encourage Cal-Am and Santa Cruz County to use our alternative dispute resolution program, either as a substitute for or in tandem with court litigation.

## **II. Background**

The Commission regulates water service provided by Cal-Am in its nine California districts pursuant to Article XII of the California constitution and the Public Utilities Code.<sup>3</sup> The Monterey and Felton districts are approximately

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<sup>1</sup> In addition, we expand the scope of review for the 2009 outside audit proposed by Cal-Am and DRA.

<sup>2</sup> The cap will be calculated to include the rate increase and balancing account amortization authorized in D.05-09-044.

<sup>3</sup> The Commission regulates all prices and terms of service of all investor-owned water utilities operating in California.

50 miles apart; Monterey is located on the coast south of Santa Cruz and Felton is located in the mountains east of Santa Cruz.

There are approximately 39,000 connections in the Monterey district, and of these about 37,600 are “main system” customers who rely on the Carmel River system and Seaside Basin as their primary water sources. The district and the entire Monterey peninsula have long-term water supply problems, which became immediate and pressing when the State Water Resources Control Board (SWRCB) issued Order No. WR 95-10 (Order 95-10) on July 6, 1995. In this order, the SWRCB (1) determined that Cal-Am did not have legal right to about 10,730 acre-feet annually of the water it was diverting from the Carmel River aquifer (about 69% of the water Cal-Am then supplied to its customers), (2) set a production limit for water that could be pumped, (3) required Cal-Am to implement environmental mitigation measures, and (4) required Cal-Am to actively pursue a replacement source of water.<sup>4</sup> All but two of the 16 special requests in Cal-Am’s Monterey application relate to its water supply issues.

Felton is a small, self-sufficient water district of approximately 1,300 customers located in a redwood rainforest. All water for the district is surface water taken from three springs. Water quality is high and the system has one relatively new treatment plant, brought online in 1997 to meet the requirements of the Surface Water Treatment Rule.<sup>5</sup> The Felton district was acquired by Cal-Am in 2001 as part of its purchase of the water utility assets of Citizens Utilities Company of California (Citizens).

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<sup>4</sup> Order 95-10 is Exhibit 72.

<sup>5</sup> This plant was funded with California Safe Drinking Water Bond Act loans and is being repaid through a special surcharge.

On July 26, 2005, a special election was held in Felton on Measure W, an \$11 million bond proposal to acquire the water system from Cal-Am through Community Facilities District No. 1. With 64% of the registered voters casting ballots, Measure W passed 74.8% to 25.2%, and Santa Cruz County has begun negotiations with Cal-Am.<sup>6</sup>

Cal-Am's GRC applications for the Monterey and Felton districts were made pursuant to the rate case requirements for Class A water utilities in Pub. Util. Code § 455.2 (§ 455.2) and the implementing rate case plan (RCP) we adopted in D.04-06-018.<sup>7</sup> Each Class A water utility must file a GRC application every three years. The application must have specified documentation and supporting material. For the 2005 transitional first year filings under the RCP, we adopted an expedited schedule, allowing a February 1 rather than January 1 filing date while retaining a projected completion date by the end of the calendar year; Cal-Am's Monterey and Felton applications are part of the February 2005 expedited filing schedule.

On February 16, 2005, Cal-Am filed these applications but did not serve the parties on its service list. On February 28, 2005, Cal-Am filed amended applications and served all parties. Notices of the amended applications appeared in the Commission's Daily Calendar on March 3, 2005, with protests due by April 4, 2005.<sup>8</sup>

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<sup>6</sup> Santa Cruz County Clerk's election statement is at Exhibit 24.

<sup>7</sup> Class A utilities are investor owned water utilities with greater than 10,000 service connections. All Section (§) references are to the Public Utilities Code.

<sup>8</sup> On March 21, 2005, an administrative law judge (ALJ) ruling memorialized the filing delays, confirmed the protest date, directed Cal-Am to file a revised procedural schedule by March 25, 2005, set a pre-hearing conference (PHC) for April 5, 2005, and

Protests to Cal-Am's Monterey application were filed by the Independent Reclaimed Water Users Group (IRWUG), Monterey Commercial Property Owners Association (MCPOA), Monterey County Water Resources Agency (MCWRA), MPWMD, the Commission's DRA, Pajaro/Sunny Mesa Community Services District (PSMCSD), Public Citizen, and the United States Department of Defense and other affected Federal Executive Agencies (DOD).<sup>9</sup> Protests to Cal-Am's Felton application were timely filed by Felton FLOW and DRA.<sup>10</sup> PHC statements were filed by Cal-Am, the County of Monterey and MCWRA, DOD, and DRA.<sup>11</sup>

At the April 5 PHC, the scope of issues was discussed, a preliminary expedited procedural schedule was set and public participation hearings (PPHs) were scheduled for both Monterey and Felton. Due to problems with the accuracy of numbers in Cal-Am's applications and public notices, the ALJ directed Cal-Am to quickly perform an independent verification of both applications. On April 29, Cal-Am filed its verification, with corrected pages. Cal-Am's cover letter characterizes the corrections as being of a minor dollar amount and an attached 11-page matrix details the corrections.

PPHs were held at 2 p.m. and 7 p.m. on May 12, 2005 in Monterey and on May 13, 2005 in Felton. All sessions were well attended and transcribed, and

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gave interested parties until March 30 to file PHC statements addressing the revised procedural schedule and the scope of issues in the applications.

<sup>9</sup> In 1978, the legislature created the MPWMD to provide a regional approach to managing and augmenting ground and surface water resources.

<sup>10</sup> On April 14, 2005, Cal-Am filed a reply to the protests.

<sup>11</sup> After the close of the record, the Office of Ratepayer Advocates changed its title to Division of Ratepayer Advocates (DRA). We use DRA throughout this decision.

many of the questions raised were to be responded to by Cal-Am in writing, with copies to the Commission and the service list.

On May 31, 2005, the Assigned Commissioner and ALJ issued a scoping memo that consolidated the two applications for the purpose of evidentiary hearings, removed Special Requests 2 and 3 of Application (A.) 05-02-012 from consideration in this proceeding, addressed Cal-Am's assertion that the lobbying expense documents it provided DRA were confidential, and set a procedural schedule for evidentiary hearings.<sup>12</sup>

DRA, Felton FLOW, and MPWMD served testimony on June 29 and June 30, 2005, and Cal-Am served rebuttal testimony on July 14 and 15, 2005. The parties held a noticed settlement conference on July 18, 2005 and settlement discussions continued through July and early August.

Evidentiary hearings were held at the end of July and through August 10, then continued to August 17 to consider a partial settlement agreement anticipated to be filed on August 15 by Cal-Am and DRA. On September 16, an additional day of hearing was held based on a motion by Felton FLOW to reopen the record for the receipt of additional evidence. Cal-Am later also requested, and was granted, an opportunity to reopen the record to receive additional evidence; it withdrew its request by motion filed on September 20.

Pursuant to Rule 51.4 of the Commission's Rules of Practice and Procedure (Rule 51.4), comments on the proposed settlement were filed on September 20 by Felton FLOW and MPWMD and reply comments were filed by Cal-Am on October 5. Opening briefs were filed on October 11 by Cal-Am, DOD, DRA,

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<sup>12</sup> In addition, the scoping memo set dates for Cal-Am to request interim rates and parties to request final oral argument. Special requests 2 and 3 seek cost recovery for the Coastal Water Project and are being addressed in a separate proceeding.

Felton FLOW, and MPWMD.<sup>13</sup> On October 18, reply briefs were filed by Cal-Am, DRA, Felton FLOW, IRWUG, and MPWMD. On October 21, Cal-Am and DRA filed final settlement documents.<sup>14</sup> The hearing record was submitted on October 21, 2005. No party requests final oral argument before the Commission.<sup>15</sup>

Cal-Am timely requested and was granted interim rate relief in D.05-12-024.

### **III. Issues Included in the Settlement Agreements Between Cal-Am and DRA**

In addressing the issues before us, we examine partial settlement agreements for the Monterey and Felton districts and GO expenses for all nine of Cal-Am's California districts.

We review these settlements, all of which are contested, pursuant to Rule 51.1(e), which provides that, prior to approval, the Commission must find a settlement "reasonable in light of the whole record, consistent with the law, and in the public interest." Cal-Am and DRA state each settlement is an integrated agreement, so that if the Commission rejects any portion of the settlement, each party has the right to withdraw. Further, they state that approval of the

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<sup>13</sup> Cal-Am filed a motion for acceptance of late-filed brief on October 12, 2005, and we grant the motion here.

<sup>14</sup> Pursuant to a request by the assigned ALJ at the August 17 hearings, Cal-Am and DRA submitted their earlier August 15, 2005 settlement agreement as three separate and severable agreements. These agreements show the final construction costs for Felton's Highway 9 project and the impact of D.05-09-004 on the rate impacts shown in the Felton settlement.

<sup>15</sup> As a procedural matter, we note that the transcript does not show exhibits 107 through 115 as entered into evidence. This is an administrative oversight, and we receive these exhibits into evidence here.

agreements should not be construed as a precedent or statement of policy of any kind for or against any party in any current or future proceeding.

We will first review the Monterey district application, beginning with the partial settlement, then the issues not included in the proposed settlement. We will then proceed to the Felton district application, reviewing first the settlement and then the issues not included in the settlement. Lastly, we separately review the GO settlement.

#### **IV. Monterey District Application**

##### **A. Contested Settlement Issues**

###### **1. Cost of Capital**

In reviewing this section of the settlement, our focus is on the capital structure and the cost of equity. We first examine capital structure.

The capital structure proposed in the settlement for Monterey is 56.6% debt and 43.4% equity. This represents a decrease in leverage from Cal-Am's December 31, 2004 figure of 58.78% debt for the Monterey district, and a decrease from DRA's initially proposed debt level of 59.37-60.14%.<sup>16</sup> This is also a less leveraged capital structure than the 63% debt/37% equity capital structure that Cal-Am and DRA propose for the Felton district. Because Cal-Am's cost of debt is lower than its cost of equity, imputing a less leveraged capital structure for the Monterey district results in Monterey customers being charged a higher cost of capital, and correspondingly higher rates.

Cal-Am and DRA state that they impute separate capital structures for the historical Cal-Am districts (such as the Monterey district) and the former Citizens' districts (such as the Felton district) in order to appropriately calculate

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<sup>16</sup> See Ex. 58, Chap. 1, page 1.

the synergy of the Citizens' water districts.<sup>17</sup> Cal-Am paid a premium over book value to acquire the Citizens districts; in the decision approving the merger, D.04-05-023, the Commission accepted a proposal by Cal-Am whereby it could seek to recover the premium cost in rates over a 40-year period provided it showed that synergy savings resulting from the merger were of an equal or greater amount each year.

The synergy savings methodology Cal-Am uses is based on different assumptions for the historical Cal-Am and former Citizens' districts. Cal-Am shows synergy savings for the historical districts based on each district being charged lower GO expense as a result of GO costs being spread across more districts, particularly the Arizona districts acquired from Citizens. Cal-Am shows synergy savings for the former Citizens' districts based on its cost of capital for these districts being less than Citizens'; to show this capital savings, Cal-Am uses its acquisition capital structure of 65% debt/35% equity, rather than its historical 60% debt/40% equity structure, for the former Citizens' districts.<sup>18</sup> Cal-Am first proposed to impute a separate capital structure in its last Monterey GRC and DRA did not object. Since no party challenged this proposed imputation, the Commission adopted separate capital structures in D.03-02-030

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<sup>17</sup> We discuss Cal-Am's use of separate capital structures here. We discuss other aspects of Cal-Am's methodology for calculating synergy savings and allocating the Citizens' acquisition premium cost in our review of the GO settlement.

<sup>18</sup> This was changed to 63% debt and 37% equity to recognize the retirement of \$10 million in debt related to the 2004 sale of Montara district, a former Citizens' property. See D.04-12-055.

and then subsequently applied it, in non-precedential settlements, to other districts.<sup>19</sup>

We revisit this imputation here because of the extraordinary capital investment projects Monterey customers face in this GRC cycle and beyond. We do not find reasonable or in the public interest to adopt the imputed capital structure proposed for Monterey because that structure results in Monterey customers paying higher capital costs than customers in the former Citizens' districts. Instead, the Commission should ensure that customers in the Monterey district are given the benefit of the less expensive capital structure being imputed by Cal-Am for the Felton district. As we will discuss in later sections, customers in the Monterey district have paid in the past for capital projects that were not used and useful, and customers are being asked in this proceeding to pay for the abandoned Carmel River Dam project and the uncertain San Clemente Dam retrofit project. In addition, in separate proceedings, Cal-Am is asking for approval to begin recovery for the Coastal Water Project, which has estimated project costs of over \$160 million in 2004 dollars.<sup>20</sup>

Therefore, we adopt the same capital structure for the Monterey district, 63% debt/37% equity, as Cal-Am and DRA propose for the Felton district. In the next GRC, Cal-Am must address what measures it has taken to ensure Monterey customers are given the benefit of the least expensive capital structure.<sup>21</sup>

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<sup>19</sup> Cal-Am amortizes the premium 50% to the former Citizens' districts and 50% to the historical districts; this generally reflects the total number of customers in each underlying district. Cal-Am also uses number of customers served to allocate premium costs among the nine districts.

<sup>20</sup> See Ex. 57, Chapter 13, page 2 of 12.

<sup>21</sup> For purposes of Cal-Am's next GRC filing, we take official notice of its recent application to refinance its capital structure, A.06-05-005. In Exhibit D of this

For the cost of debt, Cal-Am and DRA propose 6.98% for Monterey for all three years. Cal-Am originally requested a cost of debt for Monterey of 6.31% for 2006, 6.83% for 2007, and 6.84% for 2008; DRA's testimony accepted this proposal, and further agreed to use 5.77% for the 2005 cost of debt. On rebuttal, Cal-Am changed its proposal based on updated interest forecasts.

Our concern with the settlement is that the proposed 6.98% cost of debt is 61 basis points higher than the 6.37% proposed for Felton by Cal-Am and DRA in the separate Felton settlement. We do not have a full record to explore why Cal-Am has chosen to maintain separate cost of debt for each district, especially in light of the subsequent 2003 merger.<sup>22</sup> As we discuss above, Monterey customers should be given the benefit of the least expensive debt financing available to Cal-Am. Therefore, we adopt the Felton district proposed cost of debt, 6.37% for Monterey for each of the three GRC years. This meets our policy objective for Monterey customers and is reasonable based on the record.<sup>23</sup> In the next GRC, Cal-Am must address what measures it has taken to ensure Monterey customers are given the benefit of the least expensive debt financing available to Cal-Am.

We turn now to the cost of equity in the capital structure. The settlement proposes a return on equity (ROE) for Monterey of 10.10%. Cal-Am and DRA state that ROE is reasonable because it falls between the original positions of

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application, Cal-Am's actual equity at March 2006 is 38.6% and its projected equity at December 31, 2006, after its requested refinancing, is 37.44%.

<sup>22</sup> In D.02-12-068 we authorized RWE Aktiengesellschaft (RWE) to assume control of Cal-Am through the purchase of 100% of the outstanding stock of the parent company of Cal-Am, American Water Works (AWW). This decision requires Cal-Am to track all merger savings and flow 100% of the benefits of the transaction to ratepayers.

<sup>23</sup> The use of 6.3% is higher than the originally proposed 2005 and 2006 cost of debt.

their served testimony and is the same amount authorized by the Commission in Cal-Am's most recent GRC decision, D.04-12-055 (Coronado & Village Districts) and in the Commission's two most recent decisions for Class A water utilities (D.05-07-044 for San Gabriel Valley Water Company and D.05-07-022 for California Water Service Company).

This portion of the settlement is contested by Felton FLOW, which recommends an ROE of 8.79%. Felton FLOW requests that the Commission look at the June 24, 2005 short and long term bond and stock index yields and year to date graphs reported in the Wall Street Journal (WSJ), together with three WSJ articles discussing investors' lowered expectations. Felton Flow concludes that the return on equity required by investors in the upcoming GRC period will be lower than Cal-Am's present authorized ROE of 9.79% by at least 100 basis points.

Our legal standards for selecting a fair and reasonable return on equity have been set in three U.S. Supreme Court cases: Bluefield, Hope, and Duquesne.<sup>24</sup> Together, these cases provide that a public utility is entitled to a reasonable opportunity to earn a return on the value of its property employed in serving the public. This return should be commensurate with returns on investments in comparable companies, and should be sufficient to (1) assure confidence in the financial integrity of the company, (2) maintain its credit, and (3) attract necessary capital.

Determining a fair and reasonable ROE that meets our legal standards is a matter of informed judgment. We do not rely solely on the analytical modeling

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<sup>24</sup> Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia (*Bluefield*) 262 U.S. 679, 692-93 (1923), The Federal Power Commission v. Hope Natural Gas Company (*Hope*) 320 U.S. 591, 603 (1944), and Duquesne Light Co. v. Barasch (*Duquesne*) 488 U.S. 299, 310 (1989).

results of any one party or a specific model application but do consider the range of results that two of these models, the Discounted Cash Flow (DCF) and the Risk Premium (RP) provide. We also look to interest rate trends and interest forecasts, but temper our reliance on the predictive value of this evidence as the current market has shown anomalous behavior. In addition, we look at Cal Am's earning history, the performance of comparable companies, credit rating agencies' creditworthiness ranking of Cal-Am's parent, RWE, and the commitment of RWE to pass through all cost of capital savings to ratepayers.

We turn first to the financial models. The DCF model calculates an investor's expected ROE by looking at the current market price of a share of common stock and the present value of all future dividends that shareholders expect to receive. Cal-Am's and DRA's analysis is done using six comparable water utilities to compensate for any biases introduced by a single company's performance. Cal-Am calculates future dividend yield and then adds this to its calculated dividend growth rate, which results in an ROE of 10.3 – 10.4%.<sup>25</sup> DRA uses a blend of historical and forecasted growth rates to arrive at an average growth rate of 5.16% and adds to that an average current dividend yield of 3.29% to arrive at an ROE of 8.45%.

For the RP model, both Cal-Am and DRA use forecasts of interest rates for the upcoming GRC period, taken from reports published by UCLA's Data Resources Inc. (DRI). DRI reports are commonly relied on by the Commission in cost of capital proceedings, but in using these forecasts, our consistent practice has been to moderate changes in ROE relative to changes in interest rates in

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<sup>25</sup> Cal-Am adds a 50 basis point leverage adjustment to this ROE. We separately address the leverage adjustment below.

order to increase the stability of ROE over time.<sup>26</sup> In its RP model, Cal-Am uses DRI's forecasted interest rates for 2006-2008 of 6.08% for 30-year Treasury and 5.50% for 10-year Treasury, and then adds the 10-year historical risk premium differential for the six comparable companies, using their authorized rather than earned ROE. Cal-Am's model estimates ROE of 10.6 – 10.8%, for an overall ROE of 10.50, before the addition of a 50-point leverage adjustment. In its RP model, DRA uses DRI's forecasted interest rates for 2005-2008 of 5.69% for 30-year Treasury and 5.25% for 10-year Treasury and adds the 5- and 10-year historical risk premium differential for the six comparable water utilities using the historical differential between earned ROE rather than Cal-Am's authorized ROE. DRA's RP model yields a 10.41 – 10.59% range, for an RP recommended ROE of 10.53%, and an overall ROE, averaging DCF and RP, of 9.49%.

While we use the DCF and RP models in reaching our decision on ROE, we do not rely on Cal-Am's capital asset pricing model (CAPM). In this model, Cal-Am includes natural gas distribution utilities, an inclusion we find to be inappropriate as the risk characteristics of the two industries differ; in the last GRC decision we stated that we have "consistently and unequivocally rejected this in the past."<sup>27</sup>

Felton FLOW's testimony shows that there were some anomalies in market conditions at the time of hearing, particularly in the narrow spread between short- and long-interest yields. In addition, it introduces a July 21, 2005 WSJ article that recommends 13 stocks to investors, including RWE, citing RWE's attractive dividend yield and low payout ratio.<sup>28</sup> We find this evidence is

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<sup>26</sup> See D.05-12-043, mimeo. at 24.

<sup>27</sup> D.03-02-030 mimeo. at 66.

<sup>28</sup> See Exhibit 38, "Investors Hunt for Better Returns."

insufficient to support a finding that an ROE of no more than 8.79% is warranted.<sup>29</sup>

On the other hand, we also reject Cal-Am's request to add to its ROE a 50-basis point "leverage adjustment" to compensate the utility for its above average debt ratio. Cal-Am is not a company with more risk than comparable water companies. It has a history of strong earnings. In addition, its shareholders are already rewarded for a lower equity ratio through the amortization of the Citizens acquisition premium and our reliance on projected cost of capital savings in approving the RWE merger. In D.04-05-023, we discussed Cal-Am's long history of overearning its authorized ROE in California.<sup>30</sup> Furthermore, as Felton FLOW points out, Cal-Am claimed in the RWE merger proceeding that Commission approval of the merger would provide significant benefits to ratepayers from savings on cost of capital, specifically from increased leverage, and that these benefits would be passed through 100% to ratepayers. Felton FLOW states that the capital structure of 63% debt and 37% equity proposed by Cal-Am in the Felton settlement is within the range RWE then represented would produce net benefits for ratepayers, and is actually slightly less leveraged than the capital structure RWE represented would be used at the time of its acquisition of American Water Works (AWW),

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<sup>29</sup> On October 25, 2005, Felton FLOW filed a Motion to Strike a sentence on page 22 of Cal-Am's Reply Brief as it referenced interest rates since the time of evidentiary hearings. We deny Felton FLOW's motion to strike, and its request to reopen the record to allow Felton FLOW to submit new evidence. Cal-Am's statement is general and we will provide it the appropriate weight. The Commission in the past has taken official notice of changes that occur in the financial markets up to the time of the submittal date. See D.05-12-043, mimeo. at 25.

<sup>30</sup> D.04-05-023, mimeo. at 54.

Cal-Am's parent.<sup>31</sup> We also give weight to the fact that Cal-Am's application here shows there have been no net capital cost savings for the Monterey district from Cal-Am's debt cost reduction initiative through 2004, and none are projected for the period 2005-2008.<sup>32</sup>

Based on the discussion above, we find Cal-Am should receive no additional compensation in its authorized ROE for a "leverage adjustment." The Monterey settlement's proposed ROE is higher than the ROE proposed in the Felton settlement, 10.10% versus 9.95%. The basis of the .15% difference appears to be a downward adjustment to the Felton ROE to give recognition to the methodology used in determining the acquisition premium rather than an upward adjustment for the Monterey district to reflect a leverage adjustment.<sup>33</sup>

Because Felton's 9.95% ROE reflects considerations beyond Cal-Am's cost of equity for the coming GRC period, we will not apply it to Monterey. However, recognizing that Monterey customers should be given all cost of capital benefits possible due to the extraordinary investment projects they face, we direct Cal-Am in its next GRC filing to address why the Felton district, or any other district, should be authorized a lower ROE and the measures Cal-Am has taken to ensure Monterey customers receive the benefit of the least expensive capital carrying costs.

Finally, we find that adopting the 10.10% ROE proposed in the settlement for Cal-Am is reasonable because it falls in the lower range of the financial

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<sup>31</sup> September 21, 2005 Comments of Felton FLOW on the Settlement Agreement, page 8.

<sup>32</sup> See Exhibit 59, Chap. 9, page 7 of 7.

<sup>33</sup> We rely for this finding on the language of the settlement, Section 3.5 of Exhibit 2, and Cal-Am's assertion that the Monterey district ROE settlement does not contain a leverage adjustment.

analytical models, is consistent with recently authorized ROEs for comparable water utilities, reflects Cal-Am's strong performance history and creditworthiness, and does not include a leverage adjustment. Further, we find that an ROE of 10.10% is fair because this return is commensurate with returns on investments in comparable companies, and this return is sufficient to (1) assure confidence in the financial integrity of the company, (2) maintain its credit, and (3) attract necessary capital. Therefore, we adopt a 10.10% ROE for the Monterey district for the three upcoming GRC years.

## **2. Unaccounted for Water Percentages**

Cal-Am and DRA agree, for ratemaking purposes only, to set unaccounted for water at 8.5% for the main system, 9.0% for the Ambler/Bishop subsystems, and 10.0% for the Hidden Hills/Ryan subsystems.

MPWMD does not object to this portion of the settlement if it is clear that it is for ratemaking purposes only and the Commission recognizes that MPWMD's Expanded Water Conservation and Standby Rationing Plan effective March 1, 1999 (Ordinance 92) sets a standard of no more than 7% unaccounted for water. In its response, Cal-Am affirms that the settlement percentages are for ratemaking purposes only and then proceeds to caution against using the percentage of unaccounted for water as an indicator of the efficiency or condition of a water system, citing to industry publications and the testimony of a MPWMD witness for corroboration.<sup>34</sup>

The settlement figures are clearly stated to be for ratemaking purposes only. We find that the levels set by the proposed settlement are reasonable for

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<sup>34</sup> Based on Cal-Am's comments, we recommend that the utility and MPWMD confer on whether a different measurement should be used to meet the objectives of Ordinance 92.

ratemaking purposes because the percentages for each system fall between Cal-Am's and DRA's positions and are represented as providing levels that should create some incentive to lower the current five-year averages. Therefore, we adopt the proposed figures for ratemaking purposes.

### **3. Meter Replacements**

In the settlement, Cal-Am agrees to lower its three-year expenditures for meter replacements from \$185,500 to DRA's proposed \$37,200. This change reflects Cal-Am's past five-year history of average annual meter expense of \$13,000.

MPWMD objects to this portion of the settlement, stating more rapid replacement of existing meters would assist Cal-Am in meeting its SWRCB production limits. Therefore, it recommends that meter expense be set at \$40,000 year, as projected by Cal-Am in its Urban Water Management Plan.<sup>35</sup> In its response, Cal-Am states that the Commission should not assume that a more aggressive meter replacement plan will necessarily reduce unaccounted for water as inaccurate meter readings may be a function of the size of the meter, i.e., larger meters supporting residential fire suppression sprinklers, rather than the age of the meter.

We find that the record here supports MPWMD's recommendation of \$120,000 for the three-year GRC cycle, both in Cal-Am's testimony and in its Urban Water Management Plan. The settlement difference is less than \$100,000, and when viewed in relation to the special need to properly measure water usage in the Monterey district, we find that the settlement's proposed \$37,000 is not

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<sup>35</sup> See Ex. 60 at page 33.

reasonable, and that it is instead in the public interest to adopt MPWMD's \$120,000 recommendation.<sup>36</sup>

#### **4. Carmel Valley Main Segments 4, 5, 6, and 10**

Cal-Am agrees to DRA's slightly lower figure of \$4.2 million a year based on an updated cost review. Cal-Am identifies 9 of 23 miles of Carmel Valley Main segments that need repair: 3 miles have been completed and 3.13 miles are proposed for this GRC cycle.

MPWMD recommends that Cal-Am's replacement program be analyzed by an independent expert hired by DRA to review whether the rate of replacement should be accelerated. MPWMD also expresses concern that the Carmel Valley main dates from the 1930s and many portions suffer from extensive deterioration and produce excessive leakage. In its response, Cal-Am states MPWMD provides no evidence to support its assertion of excessive leakage.

We find the record here supports the settlement's proposed expenditures for Carmel Valley main repairs. However, we agree with MPWMD that Cal-Am customers may be unnecessarily exposed to SWRCB imposed fines if Cal-Am is not replacing sufficient portions of the main. Therefore, we direct Cal-Am, as part of its next GRC filing, to provide a specific analysis of leakage in the Carmel Valley main system.

#### **5. Bishop Treatment Plant**

Cal-Am and DRA agree that improvements to the Bishop subsystem treatment plant built in 2000 are necessary and recommend the costs of the project be recovered through an advice letter filing, capped at \$750,000; the

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<sup>36</sup> Ex. 1, Schneider Direct, Ex. A at 17.

advice letter process is used due to the uncertain timing of the project. Cal-Am's filing shows that capital projects for the Bishop subsystem from the last case and this proceeding total \$2,240,925.<sup>37</sup>

MPWMD objects to customers of the Monterey main system being required to pay for capital improvements to the subsystems of Bishop, Ambler, Ryan Ranch and Hidden Hills prior to the Commission analyzing the economic subsidies these customers may be receiving from main system customers and the environmental and financial risks that rapid expansion of the subsystems may be causing by exacerbating the overdraft in the Seaside basin. The main system is not interconnected to these subsystems, and the subsystem customers are not subject to SWRCB fines or to proposed surcharges for the Coastal Water Project. MPWMD points out that subsystem customers pay only 4% of Cal-Am's revenue requirement, yet in this GRC, proposed project expenditures for the four subsystems total \$2,150,000.<sup>38</sup>

In its response, Cal-Am states that the Bishop subsystem repair is necessary to maintain water quality. Further, many of Cal-Am's districts are composed of subsystems that are not interconnected, yet the costs of all system improvements are allocated to all customers in the district as a whole.

We disagree with Cal-Am that the Monterey subsystems should be viewed as similar to other Cal-Am districts. The Monterey district main system customers are facing extraordinary water issues, both in the need to conserve and in the need to develop new water sources. The record shows the Bishop

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<sup>37</sup> Ex. 1, Schneider testimony at Tab G, page 27.

<sup>38</sup> Ex. 76, page 12 cites to Cal-Am's request for \$400,000 for treatment plant improvements in Ryan Ranch, \$1 million for Ambler Park water tanks, and \$750,000 for Bishop iron/manganese removal facilities.

subsystem is a small but rapidly expanding system, with new demand driven by new homes in the Pasadena subdivision that sell for over \$2 million on average.<sup>39</sup> With main system customers facing proposed surcharges for the Coastal Water Project, it may be appropriate to consider a capital improvement surcharge for the subsystem customers. We direct that Cal-Am provide, in its next GRC filing, a full breakout of all capital improvement projects undertaken in each of the four subsystems since SWRCB Order 95-10, and a breakout of estimated costs for additional capital projects planned over the coming ten years.

While we find a comprehensive analysis should be done on this issue, the record does not support delaying plant investment in this GRC period that Cal-Am represents is necessary to comply with water quality regulations. Therefore, we approve the ratemaking treatment proposed in the settlement for the Bishop treatment plant.<sup>40</sup>

**6. Special Request 4 – Establishment of a Water Revenue Adjustment Mechanism (WRAM) Account to Track Emergency Rate Overcollections**

Cal-Am and DRA agree to establish this balancing account to return any overcollected monies to customers consistent with the process adopted in D.05-03-012. MPWMD has two concerns with the use of the funds collected.

First, MPWMD requests the Commission clarify that no SWRCB fines will be paid from this WRAM account. In its application, Cal-Am proposed to use this account to first pay “any fines that are imposed by the SWRCB.” DRA also

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<sup>39</sup> 7 RT at 876.

<sup>40</sup> MPWMD’s concerns regarding overdrafting the Seaside basin are being addressed through the complaint Cal-Am filed in Monterey County Superior Court, discussed in Ex. 76 at pages 14-19; Cal-Am is not requesting authority to recover its litigation costs here.

objects to this use of WRAM and language permitting this use is not included in the proposed settlement. Therefore, we clarify, as requested by MPWMD, that funds from this account cannot be used to pay SWRCB fines.<sup>41</sup>

Second, MPWMD requests that any overcollections from WRAM balancing accounts, be they from this new emergency rate overcollections WRAM or the existing WRAM for the inverted rate design structure, should be applied toward conservation projects rather than being refunded directly to customers. It requests the Commission implement this ratemaking treatment in this GRC, or, in the alternative, establish a policy for the next GRC.

Cal-Am objects to MPWMD's proposal to change the WRAM refund mechanism. Cal-Am urges that the refund method set forth in D.05-03-012 for overcollections from the 2004 emergency rate structure be returned.<sup>42</sup> Also, Cal-Am says MPWMD's proposal would unnecessarily complicate the funding of conservation programs by making these programs dependent on a fluctuating balancing account.

We find that using the refund mechanism adopted in D.05-03-012 for this request is reasonable because it allows any overcollection to be quickly returned to customers, rather than waiting for the next GRC. In addition, funding levels for conservation programs should be set based on the district's needs and not fluctuate due to the WRAM balances. We are authorizing over \$1 million in conservation funding in this proceeding and these programs should have a stable base. Finally, we find the present refund mechanism directly rewards

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<sup>41</sup> Later, under Special Request 8, we further address treatment of SWRCB fines.

<sup>42</sup> The emergency rates would be implemented if Cal-Am is in danger of exceeding the water production limit imposed by SWRCB Order 95-10 and would target high-use customers.

customers who avoided the high use emergency rates through prudent water usage.<sup>43</sup>

Therefore, we adopt the proposed settlement's language on Special Request 4, with the clarification that funds from this account cannot be used to pay SWRCB fines.

### **7. Special Request 5 – Endangered Species Act (ESA) Memorandum Account**

Cal-Am and DRA agree on a memorandum account to track compliance with ESA requirements other than ESA compliance associated with the San Clemente Dam retrofit. They do not agree on inclusion of San Clemente Dam compliance costs or whether any fines levied on Cal-Am for ESA violations should also be tracked in this account.

Together with DRA, MPWMD requests we exclude from this memorandum account ESA fines and ESA compliance costs associated with the San Clemente Dam. We will address these two issues in a later section on contested issues. Therefore, we adopt here a memorandum account for ESA compliance costs unrelated to the San Clemente Dam.

### **8. Special Request 7 – MPWMD Special Conservation Surcharge**

Cal-Am and DRA agree to a conservation surcharge not to exceed \$300,000 annually from Cal-Am to MPWMD and to special reporting requirements that break out (1) conservation activities Cal-Am undertakes on its own, (2) conservation activities MPWMD undertakes from its own budget, (3) programs MPWMD undertakes under Cal-Am's emergency conservation

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<sup>43</sup> The mechanism refunds half of the overcollection directly to the high use customer who paid the emergency rates and distributes the rest of the overcollection among all ratepayers.

surcharge (Special Request 6, discussed later), and (4) conservation programs MPWMD undertakes under the surcharge proposed here.

MPWMD requests we add a requirement that Cal-Am enter a formal agreement with MPWMD. That agreement would include a description of reimbursable activities, the rates at which services are reimbursed, the invoicing format, the categorization of services to reflect Commission authorization, the reporting format, the ownership of work product, and the term of the agreement. Cal-Am states this proposal would unnecessarily complicate matters. DRA, in its reply brief, supports MPWMD.

We find conservation activity is critical for the Monterey district and the funds being provided by customers, over \$1 million a year, are substantial. Therefore, it is reasonable and in the public interest to have Cal-Am and MPWMD enter a formal agreement for the conservation funds that Cal-Am provides to MPWMD, in addition to the reporting requirements it develops with DRA. Therefore, we adopt Special Request 7 and also require Cal-Am to enter into a formal agreement with MPWMD.

### **9. Special Request 16 – Balancing Accounts**

Cal-Am and DRA propose that all current balancing accounts be refunded in accordance with standard Commission policies. MPWMD recommends that the WRAM account for rate design instead be made part of the final revenue requirement in this and future GRCs and used to fund conservation programs. As we discuss earlier under Special Request 4, we do not adopt MPWMD's recommendation as the existing methodology allows for the balancing accounts to be cleared in a more timely manner and for conservation programs to be funded based on actual needs.

**B. Uncontested Settlement Issues**

The following issues are uncontested. The settlement provides cites to the underlying testimony of Cal-Am and DRA in support of the resolution of each issue. We address these issues by category, in the order presented in the settlement.

**1. Customer Sales and Revenues**

Cal-Am and DRA agree on customer counts and the average water use per customer, including an allowance for unaccounted water. MPWMD's concerns regarding unaccounted for water percentages are addressed in the previous section.

**2. Operations and Maintenance (O&M) Expenses**

For purchased power expense, Cal-Am and DRA agree that the benchmark of kilowatt hours (kwh) per hundred cubic feet will be based on Cal-Am's recorded 2003 and 2004 kwh usage. They also agree to use the latest rates from Pacific Gas and Electric Company (PG&E), and the numbers are subject to update prior to the start of the test period. Finally, Cal-Am and DRA agree that changes in the cost per unit of electricity purchased are to be tracked in the purchased power balancing account.

Based on discussions and explanations by Cal-Am of previously provided information, the parties agree to use the current chemical costs and current usage as the base in estimating chemical costs for the GRC period. For the remaining O&M expenses, Cal-Am and DRA agree to split the minor differences.

The total O&M expense proposed for 2006 is \$5,244,200. This figure is less than the 2000-2005 historical figures used by Cal-Am (also shown at Table 1 of DRA's Exhibit 108), but it is significantly higher than the \$4,501,000 we adopted for 2003 in D.03-02-030. DRA testifies that it did a "top down" approach

whereby it escalated the total O&M cost adopted in D.03-02-030 and separately estimated purchased power based on the forecasted change in PG&E rates. The settlement states the major differences are in purchased power and chemicals, which are explained. Therefore, we find the settlement reasonable on this issue.

### **3. Administrative and General (A&G) Expenses**

The proposed settlement represents a compromise between Cal-Am and DRA that is substantial. For payroll expense, the settlement proposes \$4,443,700, a middle ground between Cal-Am's original \$4,749,700 and DRA's \$3,955,200, and reflects (1) DRA's agreement to use Cal-Am's methodology and (2) Cal-Am's agreement to remove three additional employees from its request, to reduce estimated overtime expenditures, and to remove its request for employee incentive compensation. The settlement amount is significantly higher than the \$3,750,000 we adopted for test year 2003 in D.03-02-030. The record is weak on explaining the increases. Cal-Am represents that overtime expenditures are higher due to the need to immediately make repairs to avoid water loss from leaks, and that payroll expense is higher due to offsetting reductions in O&M expense for temporary labor used historically in lieu of full-time employees. We find the settlement compromise acceptable but in the next GRC, we direct Cal-Am to provide in its testimony supporting its application a more comprehensive showing of any changes in payroll expenses that are greater than the rate of inflation.

For A&G items other than payroll, there were also substantial differences. For pension payments, the parties agreed to a separate balancing account, discussed below. In addition, under the proposed settlement, Cal-Am agreed to a substantially lower regulatory expense, and other miscellaneous amounts are not charged to ratepayers. A final difference of approximately \$200,000 was split

between the parties. The adjusted settlement figure for A&G other than payroll and pension expense is \$3,718,000.

We do not have a clear record to evaluate the reasonableness of the proposed settlement on this issue. Cal-Am has reclassified several expense items between A&G and GO. DRA's five-year comparison between total O&M, A&G, and GO in Table 1 of Exhibit 108 shows expenses have increased at a rate greater than inflation, but this table does not separate pension expenses from benefits expenses, and DRA does not provide further analysis. DRA's original position escalated Cal-Am's expenses from those adopted in the last GRC, but this is hard to rely on when Cal-Am has reclassified items. The settlement provides a table of A&G expense categories but the large difference in miscellaneous expense is not explained.

While we find the record is weak on this issue, DRA has performed a full review before reaching settlement, and no party contests this issue. Therefore, we find the settlement is reasonable, with the requirement that in the next GRC filing Cal-Am must present in its direct showing a comprehensive analysis of changes since 2000 in total O&M, A&G, and GO expenses, with pension expenses removed.

Cal-Am's minimum pension payment of \$1,052,100 is given separate treatment. Cal-Am and DRA recognize that this expense is based on minimum Employee Retirement Income Security Act (ERISA) funding requirements and can have wide fluctuations. They agree to collect pension expenses via a balancing account funded by a 3% monthly surcharge on customers' bills. We find a separate surcharge treatment of pension costs to be reasonable. We adopt this portion of the settlement and will review the 3% level in the next GRC.

#### **4. Taxes and Net-to-Gross Multiplier**

All differences in taxes other than income tax were the result of differences in projected payroll expense and capital investment. The remaining difference is due to the contested issue of the ratemaking treatment for the San Clemente Dam and will be resolved as part of that issue.

For income taxes, the parties agree that interest for tax deduction purposes should be calculated based on total rate base times the projected annual weighted cost of debt. Cal-Am agrees with DRA that differences in revenue requirement because of tax law changes should be tracked in a memorandum account for later determination of distribution. We find these methodologies reasonable.

There are no issues for net-to-gross multiplier.

#### **5. Utility Plant in Service**

We discussed and resolved earlier MPWMD's opposition to the settlement on meters, Carmel Valley Main Segment 4, 5, 6, and 10, and the Bishop Treatment Plant.

Cal-Am and DRA also reached agreement on network replacements, network extensions, tools and equipment, process plant, planning study, structural improvements to Forest Lake Tank #2, Forest Lake Tank #3, Segunda Tank, 13<sup>th</sup> Avenue Main, Segunda Tank #1, distribution improvements in Seaside, Carmel Valley reconfiguration, Carmel Valley system improvements, arsenic treatment, Carmel Valley Main Phase 1, distribution monitoring, and retirements. The rationale for the compromises reached is explained for each plant category, and we find the resolutions reasonable. The agreed amounts are:

<b>Amount Requested</b>			
<b><u>Utility Plant Item</u></b>	<b><u>Cal-Am (000s)</u></b>	<b><u>DRA Position</u></b>	<b><u>Settlement(000s)</u></b>
Network Replacements - 2004-2007	\$654.1	\$382.0	\$654.1
Network Extensions - 2005-2007	277.8	99.0	225.0
Tools and Equipment 2004 change	230.9	30.2	30.2
Process Plant - 2005-2007	1208.6	953.6	1208.6
Planning Study - 2004 Construction Work in Progress	459.4	339.0	339.0
Structural Improvements to Forest Lake Tank #2 - 2005	625.0	427.0	487.0
Forest Lake Tank #3 - 2007	5000.0	4500.0 AL <sup>44</sup>	4575.0 AL
Segunda Tank - 2006	2150.0	2150.0 AL	2150.0 AL
13th Avenue Main - 2006-2007	350.0	306.0	320.0
Segunda Tank #1 - 2007	425.0	425.0 AL	425.0
Distribution Improvements in Seaside - 2006-2007	750.0	00.0	00.0
Carmel Valley Reconfiguration - 2007	654.0	00.0	00.0
Carmel Valley System Improvements - 2006	797.0	624.0	775.0
Arsenic Treatment 2006	3530.0	3530.0 AL	3530.0 AL
Carmel Valley Main Phase 1 - 2005	1860.0	1860.0 AL	1860.0
Distribution Monitoring - 2005	1025.0	1025.0 AL	1025.0
Retirements -			
2006	774.2	774.2	659.3
2007	493.8	493.8	233.2

## 6. Depreciation Expense and Reserves

<sup>44</sup> Cal-Am would be required to file an Advice Letter (AL) at project completion before this plant could be placed in rate base.

Cal-Am and DRA agree that depreciation expense should be based on the authorized level of plant in service. The remaining difference is related exclusively to the San Clemente Dam retrofit. The parties agree that net salvage estimates should be based on the authorized level of retirements.

## **7. Ratebase Including GO Allocation**

Cal-Am accepts DRA's estimate of cash working capital, and the parties agree on deferred taxes exclusive of the unsettled issue of San Clemente Dam retrofit.

The rationale for GO allocation is set forth in the separate GO settlement. We will discuss our concerns and resolution of this issue in our later section on the GO settlement. We note here that Cal-Am and DRA include in this section an explanation of the GO rate base allocation of \$1,305,300 for 2006 and \$1,219,200 for 2007, but they do not discuss anywhere why the attached rate tables show \$3,354,600 each year in GO prorated expenses, which includes \$968,590 per year amortization of the Citizens' acquisition premium and a credit of \$370,400 in net RWE savings for 2006.

## **8. Customer Service and Conservation**

The proposed settlement states there are no issues. Cal-Am's showing on customer service is found in Exhibit 57 at Chapter 12, Section 1. DRA's report, Chapter 11 of Exhibit 88, finds nothing out of the ordinary in data compiled by the Commission's Consumer Affairs Branch (CAB) other than a number of billing related complaints. However, DRA does express concern over the level of customer dissatisfaction with Cal-Am's service expressed by customers at the Monterey and Felton PPHs and Cal-Am's lack of follow-up after the PPHs. DRA testifies:

DRA is aware of a great deal of customer dissatisfaction with Cal-Am's service as evidenced by speakers at the PPHs in Felton and Monterey on May 12 and May 13. A number of complaints were raised in those hearings, on topics ranging from no water service, low water pressure, improper notification of boil orders, billing disputes, meter reading issues, hazardous construction practices, noise, a chemical accident, the inability to get prompt or courteous service from the call center in Illinois, the failure of the call center to resolve emergency issues and the failure of the call center to register complaint calls.

ALJ Walwyn asked Cal-Am to respond to each customer personally in writing, and to serve a copy of each response to the entire service list. As of this writing DRA has not received a single response from Cal-Am to any of these complaints. DRA takes the testimony given by ratepayers at these hearings seriously, and is unable to reach any conclusions on the quality of Cal-Am's customer service lacking Cal-Am's response to the complaints and allegations raised. (Exhibit 89, Chapter 11, pages 2-3.)

Based on the comments received from customers at the Monterey and Felton PPHs and the discussion of service problems in the last GRC, the ALJ asked Cal-Am for further testimony and documentation on its national call centers.<sup>45</sup> In the evidentiary hearings, Felton FLOW also sponsored testimony from nine customers on service problems.

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<sup>45</sup> In the last Monterey GRC, DRA and MPWMD testified that service had deteriorated to an unacceptable level. Cal-Am presented rebuttal testimony attributing many of the customer complaints to start-up problems with its national call center, opened by AWW in mid-January 2002, and testified that complaints would return to more normal levels as startup problems are worked out. In D.03-02-030, we concluded that "while there are indications in the record that all may not be well in Cal-Am's Monterey Division, no party has made a competent showing of what the underlying problems might be, or how they should be corrected."

We also examined in hearings the quarterly performance reports on the national call center. As part of the RWE merger proceeding, D.02-12-068 established a quarterly reporting requirement to monitor the performance of AWW's national call center in responding to California customers of Cal-Am. The report measures the percentage of calls answered within 30 seconds, the percentage of calls abandoned after thirty seconds, and the "first call effectiveness."<sup>46</sup>

In examining the current reporting on the national call center, we discovered concerns. First, the quarterly reports are not California-specific, rather they measure all AWW subsidiaries. Cal-Am's witness stated the reports could be made California specific by mid-2006. Second, questions regarding the call effectiveness measurement elicited the information that AWW records success when the operator refers a customer complaint for a work order, not when the complaint is actually resolved. Lastly, Cal-Am provided a list of complaints kept at the regional office, Exhibit 104, but this list is considerably shorter than the list kept by CAB.

Based on DRA's CAB complaint analysis, we find the level of customer service problems is lower than the last GRC, but still remains a concern for both the Monterey and Felton districts. We have not received Cal-Am's written responses to customers testifying at the PPHs, and we direct that Cal-Am provide this as a compliance filing within 10 days. We request Consumer Service and Information Division (CSID) and Water Division review this material and, if appropriate, request further information from Cal-Am.

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<sup>46</sup> Id., Ordering Paragraph 4.

Based on our concerns with existing reporting, we direct Cal-Am to develop (1) a new quarterly report that provides California specific statistics, by district, from the national call center and that breaks out type of calls and final disposition of all complaints, and (2) a new quarterly report on all complaints received at district and regional levels and their final disposition. These reports should be developed within 60 days, routinely filed on a quarterly basis with CSID and Water Division, and served on all parties to this proceeding.

In the next GRC, Cal-Am must make a more comprehensive showing on its service quality for the Monterey and Felton districts. This showing must include additional data collected through better monitoring and reporting.

### **9. Uncontested Special Requests**

Special Requests 6, 9, 11, 12, 14, and 15 are included in the settlement and are uncontested by MPWMD.<sup>47</sup> We briefly review each here.

Special Request 6 provides for establishment of a memorandum account for emergency conservation and rationing costs billed by MPWMD. This memorandum account was authorized in the last GRC, and we continue our authorization under the same terms. (See D.03-02-030, OP 6.)

Special Request 9 is a memorandum account for MPWMD emergency rationing costs. Cal-Am would record here costs incurred under MPWMD's Ordinance 92 in the event that rationing is implemented. This account is a companion to Special Request 6 and we continue our authorization under the same conditions we adopted in last GRC. (See D.03-02-020, OP 5.)

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<sup>47</sup> Cal-Am's application contains 16 special requests. Special Requests 2 and 3 were removed from consideration by the scoping memo. Special Request 10 is moot based on D.05-09-004. Special Requests 4, 5, 7, and 16 are discussed earlier as contested settlement issues. Special Requests 1, a portion of 5, 8, and 13 are discussed under issues not included in the settlement.

Special Request 11 requests authorization for an emergency rate tariff procedure. Cal-Am's emergency tariff is presented in Exhibit G and would be triggered under the same criteria the Commission adopted in D.05-03-012 at page 6 and implemented under the guidelines outlined in MPWMD Ordinance 119. Cal-Am asks to place this tariff into effect on five days notice pursuant to an advice letter filing. We find this request reasonable and adopt it.

Special Request 12 would increase the after-hours reconnection fee from \$15.00 to \$50.00. Customers can avoid this charge by agreeing to have the reconnection made when they are not present. Cal-Am agrees not to charge any reconnection fee to low-income customers enrolled in its Program for Alternative Rates (PAR) and to advise all customers who face reconnection because of non-payment about the PAR program at the time the request for reconnection is made. This change should be reflected in Cal-Am's Tariff Rule 11.C.1. We find this request reasonable and adopt it.

In Special Request 14, Cal-Am proposes, as required by Ordering Paragraph 12 of D.02-12-068, to return to ratepayers, with interest, all net savings produced by cost savings measures enacted by its parent, AWW, as a result of a change in control to RWE/Thames. Exhibit 59, Chapter 9, page 7 of 7 shows that through 2004 Cal-Am has returned net RWE savings of \$32,000 to Monterey customers and projects to return \$69,193 in 2005 and \$370,400 in 2006.<sup>48</sup>

Cal-Am states that D.02-12-068 requires that the memorandum accounts be effective for four years following the close of the RWE transaction. The transaction closed on January 10, 2003, making the last effective date

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<sup>48</sup> For 2006, \$568,602 will already be accounted for in rates and \$370,400 will be net additional savings.

January 10, 2007.<sup>49</sup> In this application, Cal-Am states that as each year passes, the tracking of past savings becomes embedded in the normal operations, and accurate comparison to what might have occurred becomes even more difficult. Therefore, it requests authority to discontinue this memorandum account tracking as of the date of this decision.

We find it would not be reasonable to allow Cal-Am to discontinue tracking the RWE savings prior to January 2007, as Exhibit 59 shows the Monterey district will not receive significant savings until 2006. Therefore, we deny Cal-Am's request to discontinue tracking the RWE savings in a memorandum account prior to the time specified in D.02-12-068.

In Special Request 15, Cal-Am requests revision to its Rule 14.1 to comply with proposed changes by MPWMD to Ordinance 92. The revision would be made by advice letter and would cross-reference all changes to Ordinance 92 and the underlying staff report and decision. We find this request reasonable and grant the request.

## **10. Step Rate Increases**

This section of the settlement addresses the mechanism and authority for Cal-Am to file, by advice letter with supporting workpapers, the escalation year rate increase for 2007 and 2008 authorized in this decision.

The parties agree that the step and attrition increases for Monterey should be based on weather-adjusted recorded earnings for the latest 12 months ending September 30 each year, and that the language and separate capital structures previously adopted for historical Cal-Am properties and former Citizens properties should be used.

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<sup>49</sup> See Exhibit 1, Stephenson direct at page 48. Exhibit 57, Chapter 13, page 11 of 12 mistakenly uses January 2006, as does DRA in its report.

We find that this section of the settlement should be modified to reflect the actual capital structure adopted in this decision. In accordance with the Commission's policy for approving step and attrition increases, should Cal-Am's earnings, based on the recorded test above, exceed its authorized return, the requested step or attrition increase should be reduced to offset the earnings in excess of its authorized return in this proceeding.<sup>50</sup>

### **C. Action on Proposed Monterey Settlement**

Based on our review of the proposed settlement, we find that while the majority of issues are settled in a manner that meets our standard of review for settlements, there are five issues where Cal-Am and DRA do not reach a resolution we should approve. These issues are:

1. the capital structure,
2. the cost of debt,
3. the amount allocated for meter replacement,
4. the early discontinuance of tracking RWE savings, and
5. the allocated amount of GO expenses.

There are also several areas, particularly regarding tracking and monitoring customer service, justification of expense items, and capital improvements for the four subsystems, where further information must be collected and analyzed prior to the next GRC.

We do not find it reasonable to adopt the proposed settlement without changes to the resolutions of the aforementioned issues. We are also mindful that the proposed settlement does not enjoy the support of all parties in this

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<sup>50</sup> See D.05-07-022, Appendix L, page 44.

proceeding and that the two parties that oppose the settlement, MPWMD and Felton FLOW, represent public and community interests.

Therefore, we reject the settlement as a whole but find that the outcomes on all issues covered in the settlement, with the exception of those we specifically change, are individually reasonable and supportable by the record.

#### **D. Monterey Issues Not Addressed in the Settlement**

##### **1. Recovery of Costs Associated With San Clemente Dam**

Cal-Am requests it be allowed to continue to have retrofit costs for the San Clemente Dam given ratebase treatment as construction work in progress (CWIP), and to have interim ratemaking treatment adopted in the last GRC raised from \$7,073,000 to \$27,854,525 to reflect work it expects to undertake in the upcoming period.<sup>51</sup> These costs will be incurred for adding a new layer of concrete to the front of the existing dam to meet seismic safety concerns. The funds will first be spent for planning and environmental studies and later for construction. The estimated total cost of the project, expected to be completed in December 2009, is \$47 million.

Cal-Am testifies that the San Clemente Dam is a concrete arch dam constructed in 1921 and operated by Cal-Am since the 1960s. The reservoir has not been dredged and thus excessive amounts of sediment have accumulated, removing over 90% of the storage capacity.<sup>52</sup> However, Cal-Am asserts that the dam is used and useful because it provides a point of diversion in the winter months that produces energy savings to customers to the extent that the diverted

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<sup>51</sup> D.03-02-030 gave CWIP treatment to \$4,406,700 of costs incurred before January 1, 2002 and \$2,666,300 in costs estimated to be incurred in the coming GRC period.

<sup>52</sup> See Exhibit 1 and 7 RT 888. The original design storage capacity of the reservoir was 1,425 acre-feet. This has been reduced to about 137 acre-feet today.

water replaces well water that must be pumped uphill to serve customers at higher elevations; in addition, water could be diverted in emergency circumstances. Further, Cal-Am in its rebuttal to MPWMD's testimony asserts that it is not illegally diverting the water at the dam because it operates in compliance with the overall requirements of SWRCB Order 95-10, and it does have pending water rights applications. While the dam's usefulness is limited, Cal-Am testifies it is required by regulatory agencies to address seismic safety issues, and therefore its shareholders should be allowed to continue to earn a full rate of return on all costs expended, as authorized in the last GRC.

Cal-Am acknowledges it is actively pursuing other options for the dam. The National Oceanic and Atmospheric Administration (NOAA) Fisheries is one of several environmental agencies recommending the dam be removed. Because Cal-Am needs NOAA Fisheries' approval for the retrofit project, Cal-Am recognizes that the agency could require the dam's removal. Cal-Am testifies it is currently participating in negotiations with governmental agencies and organizations to share in the cost of dam removal; Cal-Am estimates the cost of dam removal to be more than its retrofit estimates.

In addition, Cal-Am recently began considering a new option for the dam, called the River Bypass Option. As part of their environmental impact report (EIR) for the retrofit project, the two EIR lead agencies, the California Division of Safety of Dams (DSOD) and the U.S. Army Corps of Engineers, are requiring Cal-Am to develop a bypass alternative. Cal-Am estimates this alternative would cost somewhere between the cost to retrofit and the cost for dam removal. Cal-Am first presented this alternative in its rebuttal testimony. The cost estimates were not reviewed by DRA.

MPWMD opposes Cal-Am's request to continue to receive ratebase treatment for the project costs. It states that San Clemente Dam retrofit costs are the largest single item in this GRC, Cal-Am has failed to exercise reasonable managerial skill and care in maintaining the dam, and Cal-Am has not met its burden of proof to have costs included in rates. MPWMD testifies that Cal-Am was advised in a 1981 DSOD report to conduct a seismic stability analysis but that it waited until the early 1990s to retain a consultant to perform the study. Further, Cal-Am ignored the reservoir sedimentation problem to the point that the dam is no longer used and useful, and will not be after the retrofit. The reservoir feature of the dam has not been used for 10-15 years and the spillway gates have not been used since 1966.<sup>53</sup>

In addition, MPWMD testifies that due to a conservation agreement Cal-Am entered with NOAA Fisheries in 2001, it can only use the dam as a diversion point when the river flow is above 21 cubic feet per second, which effectively limits the use to the winter months, when Cal-Am has sufficient water other than in emergency conditions.<sup>54</sup> Lastly, MPWMD asserts that for the Commission to continue to allow ratebase treatment for the project violates Section 727.5(e)<sup>55</sup> because the retrofit project is not a used and useful investment, it will not maintain the reliability of water service, nor minimize the long-term

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<sup>53</sup> Ex. 1, Feizollahi and testimony in transcript, 7 RT 888.

<sup>54</sup> Ex. 1 and 7 RT at 890-95.

<sup>55</sup> Section 727.5(e): In establishing rates for recovery of the costs of used and useful water plant, the commission may utilize a capital structure and payback methodology that shall maintain the reliability of water service, shall minimize the long-term cost to ratepayers, shall provide equity between present and future ratepayers, and shall afford the utility an opportunity to earn a reasonable return on its used and useful investment, to attract capital for investment on reasonable terms and to ensure the financial integrity of the utility.

costs to ratepayers, nor provide equity between present and future ratepayers. MPWMD urges the Commission to thoroughly review the project in a separate proceeding, or in the alternative, adopt DRA's recommendation to place the costs in a memorandum account for later review.

DRA opposes Cal-Am's request because the solution to the San Clemente Dam safety issue is still uncertain and the dam's future usefulness is unclear. DRA finds the project is similar to the Coastal Water Project in that the scope is still uncertain, and the project is years away from completion. The case law on granting CWIP ratebase treatment to water utilities is for short-term projects, as discussed in D.03-09-002. Consistent with the Commission's ratemaking treatment of the Coastal Water Project in that case, the San Clemente dam retrofit costs should be placed in a memorandum account and accrue interest at the 90-day commercial paper rate. Further, after reviewing the cost estimates, DRA recommends that the costs be capped for this GRC period at \$23,997,940, primarily due to excessive management and contingency fee estimates. When Cal-Am completes its environmental review and chooses a final project, it can file a separate application.

### **Discussion**

We agree with MPWMD and DRA that the San Clemente Dam retrofit project is uncertain, and ratepayers should not be required to fund estimated project costs until the Commission has fully reviewed a final project proposal, either in the next GRC or by separate application if Cal-Am is ready to proceed before its next GRC. The funds Cal-Am has and will expend that are associated with this project should be placed in a memorandum account with interest to accrue at the 90-day commercial paper rate until this review is complete, subject to the cap recommended by DRA.

Our position is consistent with the treatment we authorized Cal-Am's Coastal Water Project in D.03-09-002. In that decision, we found CWIP treatment should only be used for water utilities' construction projects that are of short-term duration, and we directed the costs of a longer term project, especially one with uncertainties as to whether ratepayers would realize benefits, should be booked into a memorandum account.<sup>56</sup>

The Commission articulated its policy in D.03-09-002 after it had issued D.03-02-030 in Cal-Am's last GRC. We find that D.03-09-002 should guide us here. In D.03-02-030, we proposed an interim ratemaking treatment with the expectation that a final project would be before us in this GRC and, in doing so, we did not find it necessary to fully consider the history and purpose of CWIP treatment for water utilities. The policy articulated in D.03-09-002 is consistent with our policies for energy utilities. We do not afford ratebase treatment for electric and natural gas construction projects and, further, we have statutory provisions, such as Section 455.5, that require a utility notify the Commission if a facility in its ratebase is out of service for nine or more consecutive months. Section 455.5 also applies to water utilities and is consistent with our holding that construction projects of long duration, because they are not used and useful, should not remain in rate base.

We find the cost cap recommended by DRA for the memorandum account is reasonable. We are allowing Cal-Am carrying charges on this account, and therefore we should remove cost estimates that are excessive. DRA does not adjust for 2004 costs that Cal-Am has already incurred. For 2005 and 2006, DRA lowers to 5% Cal-Am's use of a 10% factor for company administration of

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<sup>56</sup> D.03-09-002, mimeo. at 21 and 22.

consultants. DRA bases its recommendation on R.S. Means 2005 Edition of Construction Cost Estimates for the Western Region (R.S. Means). On the same basis, DRA lowers Cal-Am's 30% factor for project contingencies to 10%. In addition, DRA notes the only key activity will be studies, not construction. For 2007, DRA uses similar R.S. Means estimates to adjust for estimated design fee, administrative costs, construction contingencies, and inspection costs.

In establishing a cap on this account, we are not finding the costs reasonable. All costs booked into a memorandum account are subject to a reasonableness review before being included in ratebase; Cal-Am can make this showing either in a separate application or in its next GRC filing. The cost cap we adopt is \$9,379,525 for 2004, \$1,321,590 for 2005, \$1,863,825 for 2006, and \$11,433,000 for 2007; the total cap is \$23,997,940.

## **2. Special Request 1: Carmel River Dam**

In Special Request 1, Cal-Am seeks authorization from the Commission to recover all its historic and now stranded costs related to the Carmel River Dam and Reservoir Project (Carmel River Dam). It seeks to recover \$3,646,452 through a six-year monthly meter surcharge. Generally, utility shareholders must bear the full costs of abandoned projects.<sup>57</sup> The Commission has recognized a limited exception to this principle when it has found that ratepayers may be responsible for some of the costs of an abandoned project during times of dramatic and unanticipated change where the utility can demonstrate that it exercised reasonable managerial skill.<sup>58</sup>

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<sup>57</sup> See *Re Pacific Power and Light Company*, (1984), 15 CPUC 2d, 118, 119 (D.84-05-097).

<sup>58</sup> See *Re Pacific Gas and Electric Company*, (1984) 15 CPUC 2d 123 (D.84-05-100) and D.89-12-057, *Re Pacific Gas and Electric Company* (1989) 34 CPUC 2d 199, 269

In the last GRC, pending the Carmel River Dam project either being put into service or abandoned, the Commission allowed Cal-Am to place into rate base as CWIP \$2,852,900 in pre-1/1/02 expenditures and \$750,000 per year for each of 2003, 2004, and 2005 and earn a rate of return of 8.56% on \$5,102,900. In that decision, D.03-02-030, at page 44, we state that this ratemaking treatment was temporary and that when Cal-Am filed its next GRC it should remove from CWIP any amounts that were not spent on the Carmel River Dam and propose a final ratemaking treatment.

In its direct testimony, Cal-Am supports its request.

Prior to selecting the Coastal Water Project as the long-term water supply solution for customers of the Monterey District, Cal-Am focused on securing the permits and rights for the Carmel River Dam project. Environmental studies, however, revealed the Carmel River Dam would have potentially unacceptable impacts, including impacts on endangered species. Political opposition in the local communities added to the likelihood the Carmel River Dam could not proceed. Cal-Am still believes that the Carmel River Dam is the most cost-effective alternative, but also recognizes that obtaining the permits to build it would be impossible. Additionally, unlike the Carmel River Dam, the Coastal Water Project is not prone to water supply limitations in an extended drought.

For projects such as the Carmel River Dam, the Commission requires Cal-Am to investigate and compare the cost of alternatives and to evaluate those alternatives prior to completing significant capital investment projects. In fact the Carmel River Dam will be used as one of the alternatives to the Coastal Water Project in the Coastal Water Project environmental analysis. These Carmel River Dam costs should

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(D.89-12-057) and *Re Southern California Edison Company* (1996) 68 CPUC 2d 25, 31 (D.96-09-039, affirmed in D.97-01-047).

be recovered from the customers that benefit from the investigation. (Exhibit 1, Stephenson, pages 31 and 32.)

In its report, DRA provides a comprehensive analysis of the six-year Carmel River Dam project and recommends that the Commission disallow the entire \$3,636,452 because Cal-Am fails to show that an exception to our used and useful standard should be granted under the criteria we established in D.84-05-100 and later cases. DRA testifies Cal-Am did not undertake this project in a time of extraordinary change or great uncertainty and did not act reasonably in (1) selecting this project rather than pursuing other alternatives, (2) properly assessing and regularly reevaluating the risks of community opposition and environmental uncertainties, and (3) continuing to actively pursue the project and incur costs for six years when the legal, regulatory, and political risks that led to abandonment were well known for some time prior to this. According to DRA, Cal-Am fails to document how the risks and uncertainties of the Carmel River Dam project were identified and analyzed, what weight they were given, and why they were dismissed from consideration. DRA testifies no further ratepayer recovery is warranted, especially in light of the fact that, without the Commission finding Cal-Am acted in a reasonable manner, customers have already paid Cal-Am \$933,000 on this project.<sup>59</sup>

DRA also places the Carmel River Dam project in the context of the long history of water supply problems on the Monterey peninsula and the large amount of money that customers have already paid for this and other projects that never materialized. In the early nineties, ratepayers paid \$1.5 million plus interest in preliminary costs for Cal-Am's proposed Canada de la Segunda

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<sup>59</sup> This has occurred because the CWIP treatment allowed Carmel River Dam costs in the last GRC.

reservoir that was never built. Ratepayers are still paying the \$1.25 million plus interest for the Plan B water supply contingency plan required by Assembly Bill 1182 in 1998 and, in a separate proceeding, Cal-Am is requesting ratepayers start paying preconstruction costs on the Coastal Water Project. Potential future costs include the San Clemente Dam retrofit, estimated to be \$47 million, and discussed in the previous section. Finally, DRA points out that Cal-Am's Carmel River Dam figures do not include the costs paid by Monterey residents to MPWMD for preliminary work on its proposed New Los Padres Dam. The Carmel River Dam is physically identical to the New Los Padres Dam project sponsored by MPWMD that was earlier defeated by voters; DRA asserts that ratepayers are being asked to cover the costs of a project that they have already paid for once.<sup>60</sup>

In its rebuttal, Cal-Am asserts it acted reasonably to pursue a project that was already well along in the regulatory review process and could, therefore, be implemented much faster than any other water supply project. Key regulatory agencies such as SWRCB had already extensively reviewed and approved the Los Padres Dam project and were supportive of Cal-Am pursuing the project. In addition, Cal-Am interprets responses to a 1995 voter survey it commissioned after the Los Padres Dam project was defeated to show some public support for Cal-Am, rather than MPWMD, to proceed with a dam project provided it did not have a growth component. On the issue of why it continued to pursue the Carmel River Dam until August 2003, even after MPWMD requested it withdraw

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<sup>60</sup> DRA testifies the survey Cal-Am conducted of voters in November 1995 on their views of the Los Padres Dam project does not support Cal-Am's conclusion that voters would support the same project if the water proposed for new growth was reallocated to fire protection and increased river flow and the project was funded and managed by a private water utility instead of MPWMD.

the project in January 2002 and Cal-Am itself in February 2003 had applied to the Commission to replace the Carmel River Dam with the Coastal Water Project, Cal-Am testifies that it needed to always have an active project before the SWRCB or it would face substantial fines. Further, it states that DRA should have no objections to Cal-Am recovering costs incurred in the later years because they largely related to Plan B.<sup>61</sup>

In its brief, Cal-Am asserts it has prudently managed its efforts to identify and implement a long-term replacement water supply, and its efforts meet the standards set by the Commission for recovery of abandoned plant from ratepayers. Further, it states that if the Commission denies its request, we run the risk of discouraging infrastructure investment by utilities.

### **Discussion**

The instances of the Commission granting a utility rate recovery for abandoned plant are rare and only done in extraordinary circumstances. The Commission's general principle is to only allow recovery in rates of the reasonable and prudently incurred costs for investments that are found to be used and useful in providing service to ratepayers. The standard of review cited by both Cal-Am and DRA for a utility's ratepayers to share in the costs of abandoned projects is the criteria set forth in D.84-05-100, and later cited by the Commission in D.89-12-057 and D.96-09-039. In these decisions, the Commission found that in periods of great uncertainty for utility planners, it could be

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<sup>61</sup> DRA in its brief states MPWMD did not begin work on its expanded EIR until April 2003. According to DRA, the invoices attached to Cal-Am's rebuttal show that from this point onward, Cal-Am was charged for only 40% of MPWMD's EIR costs because MPWMD had chosen to expand the EIR to cover other alternatives. Therefore, DRA questions whether any of the Carmel River Dam project costs here are associated with reviewing the other alternatives, including those now in the Coastal Water Project.

appropriate for ratepayers to bear some of the costs incurred for a project which is ultimately canceled if the utility demonstrates that it has exercised reasonable managerial skill in (1) identifying, assessing, and to the extent possible, quantifying the risks relevant to its ability and obligation to maintain adequate and reasonable service (“identifying relevant risks”), (2) analyzing projects such that the choice of project reflects an overall strategy to minimize costs, consistent with quality and dependability of service (“analyzing particular projects”), and (3) frequently reviewing its project commitments and overall supply strategy (“reevaluations”).<sup>62</sup> In discussing the exception to our used and useful standard, we stated:

The exception is the product of the period of dramatic and unanticipated change, initiated most notably for utility planners by the oil embargo of 1973, and extending for almost a decade. The period was characterized by great uncertainty in the energy industry, both as to demand growth and availability of supply. During such a period, a reasonable utility management can still reduce risk, but not necessarily to a level at which the shareholder may fairly be expected to absorb all the costs of canceled projects. During such a period, the ratepayer should participate in the increased risk confronting the utility.

But the ratepayer does not become the utility’s underwriter in a period of high risk. At all times, the shareholder will bear some of the risks of abandoned projects. The utility should bear a major part of the risk in order to provide proper management incentives. Also, the ratepayer’s participation is limited to those abandoned projects, or those portions of projects, for which the utility demonstrates to us that it has exercised reasonable managerial skill. We emphasize that the utility bears the burden of proof of reasonableness, not only with respect to the planning and conduct of a given project, but also regarding the

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<sup>62</sup> D.84-05-100, 15 CPUC 2d at 123 and 124.

cancellation, which must have occurred promptly when conditions warranted. Finally, a perception merely of generalized and ill-defined risk will not suffice to invoke this exception to the “used and useful” principles. The utility will have to demonstrate that the project which it ultimately abandoned was reasonable throughout the project’s duration in light both of the relevant uncertainties that then existed and of the alternatives for meeting the service needs of its customers. (D.84-05-100, 15 CPUC 2d 123, 126.)

We should apply these standards here. We first examine the requirement that a cancelled project is only eligible to be considered for cost recovery from ratepayers if it was planned during a period of dramatic and protracted uncertainty and unusually high risk. Cal-Am has actively pursued projects to obtain additional water supply for the past 15 years, beginning with the proposed Canada de la Segunda reservoir project, amid protracted uncertainties of supply availability and high risk. This uncertainty continues today with the Coastal Water Project, which has yet to be reviewed and approved.

We find that the issuance on July 6, 1995 of SWRCB Order 95-10, which found that Cal-Am did not have legal right to approximately 10,730 acre-feet annually of water it was diverting from the Carmel River, followed by the defeat in November 1995 of MPWMD’s Los Padres Dam project, constitute a dramatic and unanticipated change. The water Cal-Am was found to be illegally diverting constituted approximately 69% of the water being supplied by Cal-Am to its customers. Order 95-10 required Cal-Am to diligently proceed in accord with a time schedule to obtain the right to additional water supplies or face enforcement action. The order listed three options for Cal-Am to obtain new water supplies, two of which relied on MPWMD’s Los Padres Dam project. Cal-Am has

operated under Order 95-10 for over ten years, thus meeting the criteria of protracted uncertainty and unusually high risk.

We next examine whether Cal-Am applied reasonable managerial skill to the costs it is seeking to recover for the Carmel River Dam project. Cal-Am is requesting recovery of \$3,646,452 it spent for mostly environmental studies and preliminary work to secure project approval. We use the three criteria adopted in D.84-05-100 and used as precedent in D.89-12-057 and D.96-09-039.

**1. *Identifying Relevant Risks.*** This criterion requires the utility to show it has identified, assessed, and to the extent possible, quantified the risks relevant to its ability and obligation to maintain adequate and reasonable service. In its rebuttal testimony, Cal-Am states that the Carmel River Dam project was the most cost-effective and environmentally benign water supply project under the facts and circumstances that existed when Cal-Am undertook the project. It was a project that had already completed the environmental review and permitting process and could therefore be put in place in the shortest time possible.<sup>63</sup> Cal-Am states there were no other feasible alternatives at the time, and the record supports this. This fact is critical due to the requirement of Order 95-10 that Cal-Am actively pursue additional water supply. Cal-Am did consider the potential listing of steelhead and the redlegged frog as “threatened” under the ESA and relied on the SWRCB’s assessment in D.1632 and its own continuing work with MPWMD, California Department of Fish & Game, National Marine Fisheries Service (now known as NOAA Fisheries), the U.S. Fish & Wildlife Service, and U.S. Forest Service.

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<sup>63</sup> In September 1994, the New Los Padres Dam’s EIR was certified, and on July 6, 1995, the SWRCB issued D.1632, which summarized the environmental work done and granted MPWMD the water rights to support the diversion to storage required by the project.

When environmental concerns grew after MPWMD issued its Draft Supplemental EIR on the Carmel River Dam project, Cal-Am states that due to Order 95-10, it had to continue with the project until it was certain there was a viable alternative. We accept this as reasonable management behavior given that Cal-Am had to work with the SWRCB in order to avoid enforcement action and to work with the Commission to identify other alternatives under the 1999 Plan B requirements of Senate Bill 1182. We also find persuasive DRA's Table 13-2 "Summary of Carmel River Dam Costs by Category, Vendor, and Year" which shows that while Cal-Am continued the Carmel River Dam project, its cost outlays declined in 2002 and 2003, with the largest category of costs being payments to MPWMD. (Exhibit 88.)

**2. *Analyzing Particular Projects.*** This criterion requires that the utility's choice of projects reflect an overall strategy to minimize costs, consistent with quality and dependability of service. Cal-Am asserts that when it proposed the Carmel River Dam project, it was the most cost-effective and environmentally feasible means of meeting the requirements of Order 95-10. This is borne out by the original New Los Padres Dam EIR which was certified in September 1994, and the Carmel River Dam draft EIR issued by MPWMD in November 1998. For the Carmel River Dam EIR, although the Court of Appeals later required a supplemental report on the narrow issue of viticulture, the Court stated the rest of the EIR fully complied with the California Environmental Quality Act.

While several events going forward affected the viability of the project, particularly increased environmental concerns, another feasible project was not clearly established until after the Commission completed the Plan B process and Cal-Am was able to analyze the Plan B report published in August 2002. While DRA is correct that Cal-Am does not provide formal cost studies, it did actively

participate and support the Commission's Plan B process. The record supports a finding that Carmel River Dam was the most cost-effective alternative and that another alternative did not clearly emerge until the completion of the Plan B process.

**3. *Reevaluations.*** We require that utility management have reviewed at least annually its project commitment and overall supply strategy. While Cal-Am did not document a formal annual review process, it did testify to regular meetings with key agencies and constituents and an on-going reevaluation of the feasibility of the project. A key concern raised by DRA is whether Cal-Am's management properly assessed the political feasibility of the project after the Monterey constituents of MPWMD rejected the Los Padres Dam project by 57%. Cal-Am did not provide the evidence necessary to sustain its claim that its survey showed voters would favor a similar project if it was done by Cal-Am rather than MPWMD and if the "growth" portion of the project were instead dedicated to providing extra water for public trust resources.<sup>64</sup>

However, we find persuasive Cal-Am's testimony that key agencies, the SWRCB, the Commission, and MPWMD, all supported Cal-Am pursuing the Carmel River Dam project when it first made its decision and that support continued over the period in question except for MPWMD, which requested that Cal-Am withdraw its application in January 2002. The record is not as clear as to whether Cal-Am should have abandoned the Carmel River Dam project earlier

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<sup>64</sup> Cal-Am did not have in its possession the full survey when it made these assertions. It was able to obtain a copy on the last day of hearing. The survey was voluminous and Cal-Am's request to enter it as a late filed exhibit was opposed. By ALJ ruling, a schedule was established that provided DRA an opportunity to review the material, prepare testimony, and cross-examine. Shortly thereafter, Cal-Am withdrew its request.

than August 2003. Certainly, the issues of environmental and political infeasibility that are cited in Cal-Am's direct testimony were present well before 2003. In response, Cal-Am asserts that due to the requirements of Order 95-10, it did not have the option to withdraw the Carmel River Dam project until it had approval for another alternative. In examining this assertion, we look at the language the Commission used in discussing this project in its 2003 decisions, both D.03-02-030 and D.03-09-022. In neither decision do we express concern that Cal-Am has yet to abandon the Carmel River Dam project. This supports Cal-Am's position that its actions through August 2003 were viewed as reasonable by key agencies.

We find that operating under Order 95-10, and later the additional requirements of the Plan B legislation, has meant Cal-Am's management had less control than a utility normally has over the timing of the Carmel River Dam project. Given these constraints, we find Cal-Am's management has acted in a reasonable manner.

In summary, based on the requirement of Order 95-10 for Cal-Am to always be actively pursuing a water supply project, the initial cost-effectiveness of the project, the environmental approvals through 1999, and the support of key agencies for its actions, we find Cal-Am acted reasonably in pursuing the Carmel River Dam project and then in waiting until it had approval for an alternate project, the Coastal Water Project, to cancel the project.

Therefore, Cal-Am has shown that Carmel River Dam is an abandoned project eligible to be considered for rate recovery because its management acted reasonably, not only with respect to the planning and conduct of the project, but also regarding the cancellation. We see close consideration of the Carmel River Dam project as a necessary step in the road that Cal-Am, Monterey district

residents, and state and local governmental agencies are taking to address the drought cycles and shortage of water on the Monterey peninsula. Thus, we find that the costs Cal-Am incurred for the Carmel River Dam project, \$3,646,452, are reasonable and should be recovered from ratepayers.

We next turn to consideration of the specific method and timing of that cost recovery. In D.84-05-100 at page 127, we stated that the Commission's policy is to not allow carrying costs, Allowance For Funds Used During Construction (AFUDC), on cancelled projects for which we have granted cost recovery unless peculiar circumstances of the project warrant otherwise. We should apply this policy here, especially in light of the extraordinary ratebase treatment Cal-Am has received for the past three years on the Carmel River Dam project.

The Commission in D.03-02-030 adopted CWIP ratemaking treatment for Carmel River Dam costs, stating this was a temporary treatment until the project was either put into service or abandoned, at which time the Commission could evaluate whether and how much of the expenditures should be allowed into rates permanently. The Commission has previously granted CWIP treatment, rather than AFUDC, to water utilities because their projects are generally of short duration. There is no precedent however, to grant ratebase treatment to a project whose construction time is of a long duration and with a high expectancy of being abandoned. In D.03-02-030, the Commission not only departed from precedent in granting CWIP treatment, we provided funds for Cal-Am which exceeded its costs.<sup>65</sup>

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<sup>65</sup> The decision approved \$2,852,900 in pre-1/1/02 expenditures and \$750,000 per year for each of 2003, 2004 and 2005 and a rate of return on rate base of 8.56%. D.03-09-022

Applying the policy set in D.84-05-100 and recognizing the three years of extraordinary ratebase recovery already granted Cal-Am, we find it would be unreasonable to grant AFUDC on the \$3,646,452. Therefore, we direct Cal-Am to place the Carmel River Dam project costs in an interest-free balancing account and to collect the costs through a meter surcharge over the next six years.

### **3. Inclusion of ESA Fines in Special Request 5**

Cal-Am requests recovery of both ESA compliance costs, to include annual compliance costs for the San Clemente Dam, and any fines imposed for failure to comply with ESA requirements. It states fines would be due to claims related to damage done to the steelhead and red-legged frog in conjunction with Cal-Am's operation of its Monterey water production system.

DRA and MPWMD oppose this request. Both testify that Cal-Am has considerable management control over whether the regulatory agencies enforcing ESA requirements impose fines and that "even entertaining the possibility of passing fines through to ratepayers is extraordinary".<sup>66</sup> DRA notes Cal-Am's testimony that it has negotiated an agreement with the US Fish and Wildlife Services covering the redlegged frog (an agreement that has been renewed regularly), and that with respect to the steelhead, NOAA has entered agreements with Cal-Am previously and indicates it is willing to do so again. Cal-Am's issue with NOAA is the level of mitigation Cal-Am is willing to do, and this is again within the utility's control, not the customers.

We agree with DRA and MPWMD that Cal-Am has not shown that we should deviate from our policy of not allowing recovery of fines. The record

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later required that Cal-Am adjust its revenue requirement request in this GRC to remove from CWIP any amounts greater than actual costs. (Ex. 88 at 14-9.)

<sup>66</sup> D.98-08-036, 81 CPUC 2d 648, 653.

shows that it is within Cal-Am's management control as to whether Cal-Am incurs ESA fines. We will grant memorandum account treatment only for ESA compliance costs.

On whether annual ESA compliance costs for the San Clemente Dam should be tracked in this memorandum account or in a separate account, we will track ESA compliance costs with other San Clemente costs. MPWMD asserts these costs may not have been reasonably incurred, and DRA states that the nature of the San Clemente ESA activities is distinct from other traditional ESA compliance activities. The record is unclear whether these are operating costs being booked elsewhere already or are capital costs already included in Cal-Am's project cost estimates. Therefore, Cal-Am should book all San Clemente Dam related costs into one memorandum account where the Commission can conduct a comprehensive reasonableness analysis.

#### **4. Special Request 8 – Memorandum Account for SWRCB Fines**

Cal-Am seeks authority to establish a memorandum account for SWRCB fines for this GRC period. It seeks first to recover these fines through the WRAM account under Special Request 4, but as discussed earlier, this request should be considered separately, as has been our practice since we established the original criteria for recovery of SWRCB fines in D.98-08-036. Cal-Am states that under MPWMD's Ordinance 92, and the various programs it mandates, Cal-Am and MPWMD have established a plan that, if adhered to by the customers, will assure compliance with Order 95-10. To complement Ordinance 92, Cal-Am also requests here an emergency rate tariff to take effect on short notice. Therefore, Cal-Am argues, if water production limits are exceeded, it is because customers chose not to adhere to the various conservation and rationing programs and they, not Cal-Am should be responsible for fines.

In D.98-08-036, the Commission authorized Cal-Am to establish a memorandum account for fines imposed for exceeding SWRCB Order 95-10 in water years 1997-1998 and 1998-1999. In that decision, the Commission stated that recovery of the fines would be allowed subject to review of Cal-Am's system management (including its implementation of existing conservation programs and minimization of system losses) to ensure that Cal-Am takes all reasonable steps to avoid over-pumping. Further, the Commission stated that Cal-Am's shareholders would have to absorb some portion of the fines, to the extent that Cal-Am reasonably could have avoided the over-pumping. Lastly, D.98-08-036 states that the Commission would consider in the next GRC whether to continue the memorandum account.<sup>67</sup> In D.00-03-053 and D.03-02-030, the Commission reviewed Cal-Am's request and renewed authorization for the memorandum account subject to the same conditions originally established in D.98-08-036.<sup>68</sup>

For the first time, DRA and MPWMD oppose Cal-Am's request. Both parties state that Cal-Am now has all the tools necessary to avoid over-pumping and should be held responsible for operating its water system in a manner to avoid any fines.

DRA states the Commission recognized in D.98-08-036 that even entertaining the possibility of passing fines through to ratepayers is extraordinary, and that decision required Cal-Am management to operate the system as best it can to avoid such fines. The Commission also made clear that allowing the recovery of fines was a temporary measure, expected to be of brief

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<sup>67</sup> 81 CPUC 2d 648, 652.

<sup>68</sup> D.03-02-030, mimeo. at page 51 states: "Our D.98-08-036 was carefully crafted, and we will once again authorize what we did there, but update it to apply to SWRCB fines incurred through the effective date of our order in Cal-Am's next GRC.

duration, until MPWMD could adopt its rationing plan, Ordinance 92.<sup>69</sup> DRA reviews the expanded tools that Cal-Am now has available, comments on those it has not fully utilized, and finds that Cal-Am should be held responsible for fully utilizing these tools and for operating its water supply system to avoid overproduction.

MPWMD details the provisions of Ordinance 92 and the revised Ordinance 119 Expanded Water Conservation and Standby Rationing Plan. MPWMD supports Special Request 15, which would add all provisions of Ordinance 119 to Cal-Am's tariff; however, MPWMD testifies that if the Commission compares the management tools available in 1998 to those now in place, it must conclude that a memorandum account to track SWRCB fines is no longer warranted.

### **Discussion**

Consistent with our findings in D.98-08-036, 81 CPUC 2d at 653, we find here that Cal-Am now has the management tools necessary to operate its Monterey water system and it should "assume full responsibility for managing water supply in compliance with the cutback requirement." The record shows that Cal-Am can, and should, do more to ensure conservation. First, under Stage 1 of Ordinance 92, landscape water audits are supposed to be conducted on all large residential users, large irrigators, and properties with dedicated landscape meters to set water budgets. Ordinance 92 required these audits to be completed within 180 days, or by August 28, 1999, yet after six years only 13% have been done.<sup>70</sup> By not having conducted these audits, Cal-Am cannot require these customers to curtail their usage during Stage 3 periods. Second, there are over

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<sup>69</sup> D.98-08-036, 81 CPUC 2d 648, 653.

<sup>70</sup> MPWMD/Pintar, 5 RT 668-669.

1000 commercial account audits that Cal-Am has not done, as discussed below (Rate Design). As the record reflects, the Commission has approved all of Cal-Am's requests for conservation programs, emergency rate measures, and compliance costs. Cal-Am determines the financial requests it makes in its application and cannot claim that ratepayers should bear the cost of SWRCB fines if it fails to operate its water system in a prudent manner.

Cal-Am has argued that further emergency rate measures are no longer necessary in order for it to be able to comply with SWRCB Order 95-10, and we agree.<sup>71</sup> We take notice that MPWMD has the authority to impose a water moratorium if needed, and Ordinance 119 provides the ability to more rapidly respond to a water emergency.<sup>72</sup> Therefore, we deny Special Request 8.

### **5. Special Request 13 – Rate Design**

The Monterey district has a special per-capita rate design adopted in 2000 to address the unique water supply and operating problems in Monterey. The district is in an area subject to drought on the average of every seven years and is also subject every year to the water production limits set by the SWRCB in Order 95-10. In D.00-03-053, our decision on the test year 2000 GRC, we adopted a normal increasing block design for normal times and a per-capita conservation rate design for periods when Cal-Am was likely to violate its SWRCB water production limit. For residential customers, the per-capita rate design has five sharply ascending blocks; for other categories, there are two ascending blocks.

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<sup>71</sup> In D.04-07-035, the Commission directed Cal-Am to file an application within 90 days for a moratorium on new hookups and expansions. In Cal-Am's subsequent application it stated that a moratorium is no longer a necessary step. (See D.05-04-005, mimeo. at page 4.)

<sup>72</sup> MPWMD opening brief, page 24.

To protect Cal-Am from revenue loss due to conservation, the Commission adopted a WRAM.

Soon after D.00-03-053 was issued, Cal-Am exceeded its production limit and the conservation rate design became effective. Subsequently, the Commission granted Cal-Am's petition for modification of D.00-03-053 and the per-capita rate design became permanent. In D.03-02-030, the last GRC, we reaffirmed this rate design but expressed our intent to consider eliminating the WRAM in the next GRC if revenues were found to be more predictable.<sup>73</sup>

Because it faced losing the WRAM mechanism, Cal-Am proposed a different rate design in this proceeding, one that is less customer specific and complex but still retains a conservation emphasis. For residential customers, Cal-Am proposes compressing the current 12 categories of customers, based on a water budget formula which considers persons per household, lot size, and the number of large animals, into three categories, and eliminating occupancy consideration after the first block definition. While establishing a water budget for residential customers is relatively simple, Cal-Am testifies it has performed few water audits on its commercial accounts because they are time and labor-intensive. Therefore it proposes a change to a rate structure based on meter size. If the Commission rejects this recommendation, Cal-Am requests we authorize sufficient staff to complete the existing commercial audit backlog. For its four subsystems, Cal-Am proposes to transition them over the next six years to the same rate design so that there is a regional approach to pricing and ratemaking.

DRA objects to Cal-Am's proposal, recommending instead that the Commission continue the current per-capita rate design and WRAM. It testifies

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<sup>73</sup> Id. at page 39.

that Cal-Am's proposal negates the advantages of the per-capita rate design, is less logical and intuitive, and provides less conservation incentive for small households. DRA also recommends that the current rate structure be maintained for the subsystems as these systems draw from a different water aquifer and there has not been a need established for change.

MPWMD supports portions of Cal-Am's proposal. It supports eliminating a residential per capita allocation after the first block as this should save water and facilitate compliance with SWRCB Order 95-10. Further, it agrees with Cal-Am that this modification will place less emphasis on occupants and more emphasis on outdoor water use. For these reasons, it supports Cal-Am's residential rate design proposal. For commercial customers, MPWMD states that this proceeding has revealed a significant problem that requires an immediate remedy. Specifically, Cal-Am has not conducted the required audits to prepare water budgets for over 1000 commercial accounts. These accounts are basically being billed at a flat rate and, therefore, MPWMD supports moving to a rate structure based on meter size. Should the Commission deny this request, monies should be made available to hire auditors to establish water budgets.

MPWMD opposes Cal-Am's proposal to transition Hidden Hills, Ryan Ranch, Bishop, and Amber Park subsystems toward consolidated pricing with the Monterey district because these are small, independent systems with different water sources and production issues. Further, this consolidation would enable Cal-Am to fund subsystem improvements at main system customers' expense, an issue MPWMD has raised in this proceeding.

The DOD supports Cal-Am's rate design proposal because the proposed inverted block commercial rate would enhance conservation, and the revised

residential categories would make it harder for individual residential customers to cheat the system.

### **Discussion**

In reviewing residential rate design, we find that Cal-Am has not established good cause to deviate from the existing 12 categories. Testimony shows that the existing rate design has proved effective in reducing consumption in the Monterey district and that there is no evidence of significant customer cheating under the system. As Cal-Am's witness testified, the reasons the Commission gave in D.01-10-014 for retaining per-capita rates are still persuasive today, and this type of rate structure has been successfully implemented in other water-scarce communities as a more equitable way of coping with water shortages while preserving some amount of customer choice.<sup>74</sup>

However, we should give consideration to Cal-Am's and MPWMD's concern that per capita rate design should not be retained in the higher blocks as these levels involve outdoor rather than personal water use. In D.03-02-030, at page 72, we examined the steep blocks and found that only those customers who are the very lowest users fall exclusively into the first block. Without further analysis to review, we find it would be inequitable to move too quickly away from per capita allocation in the higher blocks. Therefore, we should adopt a more gradual shift here, with a reasonable interim step being to eliminate per capita allocation only in the third through fifth blocks to promote more conservation of outdoor water use.

For commercial customers, we find that the water audits should be completed in a timely manner, before the next summer. The Monterey district

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<sup>74</sup> Ex. 1, Chestnut, page 3.

has unique water supply constraints that have caused the Commission to authorize over a million dollars a year in conservation programs and to adopt special memorandum accounts and emergency rate measures. In addition, Cal-Am is required under SWRCB Order 95-10 to actively pursue new sources of water supply, a very costly undertaking. It would not be appropriate to place commercial customers on a standard meter size schedule because Cal-Am has failed to perform over 1000 individual water audits of its commercial customers. Further, it would not be fair for residential customers to continue to bear a disproportionate burden of the conservation rate design. As pointed out in D.03-02-030, at page 72, residential customers pay commodity rates ranging as high as 400% of the standard rate, while non-residential customers' highest rate tops out at 200% of the standard rate.<sup>75</sup>

Therefore, we direct Cal-Am to undertake water audits for all of its commercial customers in a timely manner. Cal-Am states it would need additional funding to do this. Before we approve additional funding, we need to establish what level of revenues has been provided in rates since 2000 for Cal-Am to do commercial water audits. If further funding is necessary, a memorandum account may be the logical ratemaking vehicle and should be explored. Based on the record here, we direct Cal-Am to file an advice letter within 30 days providing a specific plan to complete all commercial water audits prior to May 1, 2007. This advice letter should identify the revenues provided in customer rates since 2000 for Cal-Am to undertake these audits, the number of audits performed, and, if additional funds are required, propose a mechanism to fund them.

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<sup>75</sup> Id. at 72.

Finally, we address Cal-Am's request to consolidate over a six-year period the rate design of its four subsystems. We agree with DRA and MPWMD that good cause has not been shown for this change. Further, we have directed in an earlier section that Cal-Am present a detailed study in the next GRC of the capital improvements that have been done and are projected to be done over the next ten years. We find that it is premature to consider rate consolidation until the study has been done and reviewed. Therefore, we do not adopt Cal-Am's proposal.

## **V. Felton District Application**

### **A. Contested Settlement Issues**

#### **1. Cost of Capital**

Cal-Am and DRA propose a capital structure of 63% debt/37% equity and an ROE of 9.95% for the three GRC years. They state the ROE is 10 basis points higher than the settled amount for the recent Sacramento/Larkfield districts to recognize subsequent and forecasted increases in interest rates. Further, they state the ROE is 15 basis points lower than the ROE proposed in this proceeding for the Monterey district.

Felton FLOW contests the ROE portion of this section, recommending instead an ROE of 8.79% for both Monterey and Felton districts based on current financial market conditions, with an adjustment of 50 basis points for poor service and widespread customer dissatisfaction in Felton; this would reduce the ROE for Felton to 8.29%. We have assessed Felton FLOW's cost of capital evidence under the Monterey district settlement and there adopted an ROE of 10.10%. Cal-Am and DRA propose a 15 basis point downward adjustment from Monterey's 10.10% ROE for Felton, to give recognition to the methodology used to determine synergy savings and amortization of the acquisition premium for

the former Citizens' districts. Based on this, we find an ROE of 9.95% for the district is reasonable.

We turn now to Felton FLOW's request to lower the authorized ROE due to poor service. In support of this adjustment, it cites customer witnesses in the evidentiary hearings and at the PPH who provide specific examples of Cal-Am's poor response to customer concerns and complaints, the evidence presented of Cal-Am's imprudent management of construction projects, and the overwhelming support of the local community for the public acquisition of the Felton district. Further, Felton FLOW asserts that in the past the Commission has reduced the authorized ROE of utilities that have failed to provide adequate service.<sup>76</sup>

In cases where the Commission has reduced a utility's ROE, we have found offenses or actions contrary to statute, order, rule, instruction, or express policy, as explained in *re Southern California Edison Company* (1991) 42 CPUC 2d 645, 738, D.91-12-076. For a water utility, we applied this standard in D.04-07-033 to reduce California Water Service Company's ROE by 50 basis points for its pattern of violating statutory and decisional requirements by acquiring three water systems without authorization, and in two of the water systems charging unapproved rates.<sup>77</sup>

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<sup>76</sup> Felton FLOW cites to *Re G.T.E. of California*, (1980), 4 CPUC 2d 428 (D.92366), *Re Washington Water and Light Company*, (1972), 73 CPUC 2d 284, 301-302, (D.79919), and *Re Citizens Utilities Company of California*, (1995) 62 CPUC 2d 244, 265, (D.95-11-024).

<sup>77</sup> In D.04-07-033 we also imposed a \$75,000 fine for the violations. We found the fine and the reduced ROE serve distinct purposes. "The fine punishes five distinct violations and deters other utilities from similar misconduct. The reduced ROE mitigates the harm done to Salinas District customers, but more importantly provides an incentive for Cal Water's management to better coordinate its business objectives with its obligations as a public utility." (Mimeo. at 18.)

We do not find that the evidence presented here establishes statutory or rule violations, or a pattern of behavior contrary to stated Commission policy. While the record establishes a need to more closely monitor Cal-Am's customer service quality, it does not support a finding of poor service quality. Therefore, we do not find that a reduced ROE is warranted.<sup>78</sup>

As discussed under the Monterey settlement, Cal-Am's proposed capital structure for the Felton district is reasonable and provides benefits to Felton customers. Likewise, the 6.37% cost of debt proposed for the three GRC years is reasonable and supported in the record. Therefore, we adopt the proposed settlement's capital structure, cost of debt and ROE.

## **2. O&M Expenses, A&G Expenses, and GO Allocation**

Felton FLOW requests the Commission disallow any increase in Cal-Am's combined O&M, A&G, and GO expenses due to the fact that DRA's analysis in Exhibit 109 shows these combined expenses for test year 2006 under the proposed settlement are 73.34% higher than the recorded expenses for these accounts in 2000. Felton FLOW states that the escalation in these accounts far exceeds the rate of inflation, and RWE, AWW, and Cal-Am should be required to meet the commitments they made at the time of the merger proceeding to implement efficiencies and economies of scale that would reduce these costs.

Felton FLOW also urges us to disallow 5% of the employee-related costs included in the proposed settlement for O&M, A&G, and GO for Felton because of political activities included in these accounts.<sup>79</sup> Felton FLOW introduced evidence showing Cal-Am's president Paul Townsley, its Monterey/Felton

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<sup>78</sup> We address customer service concerns again in Section V.A.8.

<sup>79</sup> Felton FLOW also recommends a similar 5% reduction to GO expense for the Monterey district.

district manager Steve Leonard, AWW's director of external affairs Kevin Tilden, and various other employees at the senior executive level as well as the Felton district level participated in meetings and a wide range of political initiatives intended to undermine the efforts of Felton FLOW, Public Citizen, and public agencies and officials to facilitate the public acquisition of the Felton district.<sup>80</sup>

We will first address Felton FLOW's proposal to allow no expense increases and then address its proposal for a 5% reduction. In recommending no increase in O&M, A&G, and GO expenses, Felton FLOW bases its recommendation on DRA's Exhibit 109, Table 1. This table contains discrepancies, two major ones being that it does not reflect the proposed settlement figures, which substantially lower A&G expenses for 2006, or the correct figure for GO expenses, which is substantially higher than shown even after excluding amortization of the Citizens' acquisition premium. In addition, the table shows the large percentage increases taking place in the years 2002-2004, the last GRC period, not 2005 and the upcoming test period. This table is not sufficient to support Felton FLOW's recommendation, therefore, we do not adopt it.

We turn now to Felton FLOW's proposal for a 5% reduction in each expense category to reflect Cal-Am's inclusion of political and lobbying activities by its employees. In its rebuttal, Cal-Am states that the consulting firm Moriah Group and Felton district's community relations manager, Evan Jacobs, were paid entirely from shareholder funds and that Kevin Tilden's time spent drafting proposed condemnation legislative changes related to the Felton district was less than 10% of his total time, and therefore not reportable under state lobbying

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<sup>80</sup> See Exs. 6-12.

laws. In addition, Cal-Am asserts that while a small amount of Leonard's and Tilden's time is spent on Felton condemnation issues, often even that small amount of time is primarily spent providing a service to ratepayers by responding to information requests.<sup>81</sup>

Based on Cal-Am's statements and the evidence of record, we find that Cal-Am did not separately record as shareholder expense all political activity and lobbying efforts by its employees. While the majority of Cal-Am's extensive campaign against Measure W is excluded from its rate request, Felton FLOW has established that Cal-Am has included in its request the time district and corporate personnel spent attending meetings on the Measure W campaign and Tilden spent drafting legislation. Therefore, an adjustment should be made, as Commission policy is clear that political and lobbying activity should not be included in customer rates.

Because Cal-Am and AWW employees did not separately track this activity, we must estimate the dollar adjustment. Felton FLOW's proposed 5% reduction is reasonable and should be adopted for O&M expenses, A&G expenses, and the Felton district allocation of GO expenses.

We turn now to evaluation of Cal-Am's and DRA's proposed settlement for these expense categories.

#### **a) O&M Expenses**

In its report, DRA states it has reviewed the O&M accounts for accuracy and tracked costs moving between accounts; in addition, DRA reviewed various invoices, and adjustments and believes that Cal-Am has properly removed duplicative, inappropriate and non-recurring charges from historical O&M

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<sup>81</sup> Ex. 14, page 7.

information. DRA's estimated total for O&M expenses is \$171,400. Cal-Am's original total exceeds this estimate by \$1600, with the difference attributable to the purchased power cost, which in turn relates to differing estimates on total water production.<sup>82</sup> In the settlement, the parties state there are no outstanding issues and agree to use the latest purchase power rates by PG&E. The attached tables reflect \$172,800 for this category. We should adopt the proposed settlement's O&M expense amount less a 5% deduction to employee-related costs. Cal-Am must provide a table showing this adjustment in its compliance filing of rate tables.

#### **b) Payroll and A&G Expenses**

Section 4.5 contains the proposed settlement reached between Cal-Am and DRA for payroll and A&G expenses. For payroll expense, DRA agrees with Cal-Am that a fifth employee, the local customer service person, is necessary and an amount of \$281,100 for 2006 payroll is proposed. In D.04-05-023, \$235,300 was adopted for test year 2003. Felton FLOW does not directly address the need for a local customer service person but based on the level of consumer complaints, we find the proposed settlement reasonable on this issue.

The settlement proposes to separately collect the minimum ERISA pension payment of \$64,100 through a 3% monthly surcharge on customer bills, reconciled with an annual advice letter filing for a surcredit or surcharge, depending on the balance in the balancing account. This is the same treatment proposed for Monterey and due to the wide swings in yearly ERISA minimums Cal-Am has experienced, we find this treatment reasonable.

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<sup>82</sup> Ex. 90, Chapter 3.

For A&G expenses other than payroll and pensions, Cal-Am and DRA settle on \$175,900 per year based on:

Cal-Am's original A&G	\$306,700
Cal-Am's revised A&G	264,700
DRA's Original A&G	91,300
DRA's Revised A&G	142,500

In supporting the proposed settlement, Cal-Am and DRA refer to changes in expense categorization between A&G and GO. These changes do not explain the significant differences between the original and revised A&G expenses since the agreed-upon GO expense allocation is an increase of only \$4,000 from DRA's original recommendation and \$40,000 from Cal-Am's position.

While we place considerable weight on DRA's review and recommendation on this issue, the explanation provided by Cal-Am and DRA in the proposed settlement is inadequate because it does not address the substantial increase in this category from the amount authorized for test year 2003 in D.04-05-023.<sup>83</sup> In its report, DRA states that D.04-05-023 did not adopt a specific figure for Outside Services and that it was not able to fully analyze increases because of Cal-Am's transfer of expenses from GO and its transfer of many other expenses among A&G accounts, making analysis of historic expenses infeasible in the time allotted.<sup>84</sup>

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<sup>83</sup> In D.04-05-023, Appendix A, the Commission adopted \$54,700 for test year 2003 in pensions, benefits, and other A&G. D.04-05-023 also adopted GO expenses of \$91,300.

<sup>84</sup> Ex. 90, page 4-4. In the proposed settlement, the parties agree to present all items of expense that are directly attributable to the Felton district in the A&G expenses and to present the American Water Service Company management expenses in the GO allocated expenses. Felton FLOW requests we disallow the cost of the compliance audit required in this case. Cal-Am states that the cost is not included and the record supports Cal-Am on this issue.

Cal-Am's comparison to present rates, Exhibit 63, Chapter 4, page 3 of 5, reflects that other A&G and Outside Services expenses in 2002 through 2004 were considerably higher than those adopted in D.04-05-023 for the same years. Reviewing the rates adopted in D.04-05-023, DRA's report, and the proposed settlement, we find that DRA's original A&G recommendation of \$91,300, rather than the proposed \$175,900 is supportable and reasonable. Therefore, we adopt this figure for other A&G.

As we discuss in the Monterey district section of this decision, we are concerned with the escalation of A&G and GO expenses, especially in light of RWE's plans to sell AWW and its Cal-Am subsidiary. Cal-Am presents testimony of projected savings that should come from RWE's Standardized Technology Enabled Process (STEP). Although projected savings from STEP over the next ten years are revised downward by its witness, Cal-Am explains that the RWE transaction was only completed in 2003 and a project the size and scope of the STEP program will take time to develop and implement.<sup>85</sup>

We intend to focus closely on the issue of A&G and GO expenses in the next GRC and we require Cal-Am to work cooperatively with DRA in providing the information necessary to fully analyze all A&G accounts. In the separate GO settlement, Cal-Am agrees that in connection with the 2009 GRC, DRA will retain an outside audit firm to review the GO operations and its cost allocations to the various ratemaking districts. Cal-Am will reimburse the Commission for the cost of the audit and it may seek recovery for the audit costs through rates in its 2009 GRC proceeding.<sup>86</sup>

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<sup>85</sup> See Ex. 86.

<sup>86</sup> The GO settlement further states in Section 5.6: "Administrative and General expenses that were previously part of GO allocations will also be audited. In addition, a

Cal-Am and DRA agreed to GO expenses of \$129,700, which include \$57,179 in amortization of the Citizens' premium and \$17,804 in a credit from RWE savings, in the Felton settlement. These expenses will be discussed later as part of the GO settlement and the amount approved for Felton should be reduced 5%.

In summary, we adopt \$172,800 for O&M, \$281,100 for payroll expenses and \$91,300 for other A&G expenses, with a 5% reduction made to each to remove political and lobbying activity. In addition, we find reasonable and adopt the proposed 3% surcharge for minimum ERISA pension payments, together with the proposed balancing account mechanism.

### **3. Taxes Other Than Income**

Cal-Am and DRA state that all differences in this account were the result of differences in projected payroll expense and capital investment. Based on the settlement of other issues, new estimates are provided for Ad Valorem tax and payroll taxes. Due to other changes we make in the Felton settlement, we do not adopt these specific figures. Cal-Am should separately calculate the amounts based on the final decision and provide all interested parties and the Commission rate tables reflecting our adjustments, as discussed later in this decision.

### **4. Income Taxes**

Cal-Am agrees with DRA that (1) interest for tax deduction purposes should be calculated based on total rate base times the projected annual

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review of Cal-Am's compliance with the Commission's affiliate transaction rules will be covered as part of the audit scope. This audit will allow the Commission to determine if Cal-Am's affiliate transactions and cost allocations are in the public interest and consistent with Commission decisions, rules, and policies."

weighted cost of debt and (2) differences in the revenue requirement because of tax law changes should be tracked in a memorandum account for later determination of distribution. These policies are reasonable and should be adopted.

As discussed earlier, the specific amount of income taxes set forth in the proposed settlement cannot be adopted due to other changes proposed in the settlement. Cal-Am should separately calculate the amounts based on the final decision and provide all interested parties and the Commission rate tables reflecting our adjustments, as discussed later in this decision.

## **5. Utility Plant in Service**

### **a) Tools and Equipment**

Cal-Am originally proposed \$118,700 and DRA \$42,000. The two parties settled on \$77,000 for the 2005-2007 period based on using five-year averages except for 2005, when DRA agreed that Cal-Am needed a new generator. We find this amount reasonable.

### **b) Process Plant**

Cal-Am originally proposed \$110,000 but agreed in the settlement to use DRA's proposed \$35,000, which is based on a five-year average for 2005. We find this amount reasonable.

### **c) Distribution Monitoring**

Cal-Am agrees to defer its \$300,000 request to a later rate case, as requested by DRA and Felton FLOW. We find this resolution reasonable.

### **d) Highway 9 Main**

Cal-Am and DRA agree to \$107,500 in rate base in 2005, the estimated final cost of this project. Cal-Am originally estimated \$150,000 and DRA recommended \$86,000. In support of its \$86,000 recommendation, DRA testifies

that a review of prior years' detailed cost records show that the Commission's approval of an existing \$300,000 in rate base is too high and should be adjusted for this final phase.

Felton FLOW contests this portion of the settlement and recommends a 20% overall adjustment and then a \$50,000 deduction in remaining costs due to Cal-Am's mismanagement of the construction project. Specifically, Felton FLOW testifies that (1) Cal-Am should not have started the project in the winter season and a 20% reduction should be made for the additional costs incurred as a result of this decision, and (2) ratepayers should not have to compensate the utility for the \$50,000 in additional costs stemming from the California Department of Transportation (CalTrans) finding that Cal-Am needed to have an independent resident engineer on-site at all times during construction due to problems.

On the decision to begin construction in the winter season, Cal-Am testifies that it was ready to start in the summer but delayed to the winter because it thought traffic would be lighter. Felton FLOW provides evidence that contrary to Cal-Am's assumptions, traffic is relatively constant on Highway 9 throughout the year, but peak period flows are actually slightly heavier during the winter than the summer.<sup>87</sup> Further, by scheduling the project to start later, anyone familiar with the Santa Cruz Mountains could reliably predict that severe winter weather would adversely impact the project and very likely result in construction difficulties, inconvenience to the public, potential safety hazards, delays in completing construction, and higher costs than during the summer. Felton FLOW presented testimony on the inconveniences experienced by customers, and the construction problems encountered.

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<sup>87</sup> Ex. 28.

On its request for a \$50,000 adjustment, Felton FLOW testifies that this is the additional amount Cal-Am paid its contractor, Bestor Engineers, for the on-site engineer required by CalTrans. In support of this adjustment, Felton FLOW introduced Exhibit 113, a January 27, 2005 letter from CalTrans detailing the project's problems and requiring the on-site engineer. In Exhibit 114, Cal-Am's rebuttal witness confirms this figure.<sup>88</sup>

Based on the evidence presented, we find a \$50,000 adjustment should be made to the Highway 9 project to reflect the construction deficiencies cited by CalTrans and Cal-Am's cost to remedy the problem. On the issue of a 20% overall adjustment, we find that while review today shows that Cal-Am erred in its scheduling, it acted on reasonable assumptions and managed to bring the project in below estimates. While residents did encounter a great deal of inconvenience due to the long weather delays, and safety issues did arise, this was largely due to an extremely wet winter. We also note that DRA decreased by \$10,000 its original settlement amount to reflect final project costs.<sup>89</sup>

The evidence regarding problems with the main replacement project on Hillcrest Drive, particularly the road resurfacing and the two inch vertical pipe shows that the Santa Cruz Department of Public Works has regularly inspected and advised Cal-Am. The county has not issued any deficiency notices and we do not find cause to take additional actions here. Based on Cal-Am's testimony, we find its handling of a chemical accident at the Felton Water Treatment Plant was reasonable.

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<sup>88</sup> Ex. 114, page 5, line 5.

<sup>89</sup> Transcript at 1166, revised settlement filed October 21, 2005.

**e) Main at Bull Creek**

On this request for \$193,000 in addition to 2005 utility plant, Cal-Am agreed, to the request of Felton FLOW supported by DRA, that if Measure W passed, it would defer any further work on this project until a final resolution to the pending condemnation of the Felton water system. The parties agree that the currently expended amounts of \$30,000 should be allowed in rate base.

**6. Depreciation Expense and Reserve**

Cal-Am and DRA agree that depreciation expense should be based on authorized level of plant in service. Cal-Am should adjust the figures used in the proposed settlement for changes made in this decision.

**7. Rate Base**

Cal-Am and DRA address working capital, deferred taxes, and GO allocation. Cal-Am accepts DRA's estimate of working cash for 2006 and 2007, the parties agree that deferred taxes should be based on authorized level of plant, and the level of GO allocation is based on the GO settlement.

We find the level of working capital reasonable, note that deferred taxes should be adjusted to reflect the changes to plant we adopt, and find that GO allocation should be based on the amount we authorize in our review of the GO settlement, later in this decision.

**8. Customer Service and Conservation**

Cal-Am and DRA have no issues in this category.

Felton FLOW objects, stating that the proposed settlement takes no account of the widespread customer dissatisfaction with the poor service provided by Cal-Am in the Felton district. It asserts that the numerous customer witnesses that testified regarding specific examples of Cal-Am's imprudent management of construction projects and poor response to customer concerns

and complaints provide sufficient grounds for the Commission to reduce Cal-Am's return on equity. It specifically cites to the testimony found in Exhibits 26, 29, 31, and 32. Cal-Am cites to its response in rebuttal testimony to the testimony of ten Felton FLOW witnesses as support that it does not have service quality problems, and also it asserts that the complaint data provided by the national call center and the regional office do not show an unusual amount of complaint activity.

We recognize the widespread customer dissatisfaction brought before the Commission at the PPHs and in the evidentiary hearings. In addition to specific service quality complaints, customers are also very angry at Cal-Am's aggressive efforts to fight Measure W; the utility in its testimony recognizes the extremely strained relationship it has with the Felton community.

In reviewing the evidence presented by Felton FLOW and Cal-Am, we find cause exists to examine further if the national call center and regional offices are promptly answering and correctly handling customer calls. As we discussed in our review of the Monterey settlement in an earlier section of this decision, we have not received Cal-Am's written responses to customers testifying at the PPHs and direct that Cal-Am provided this as a compliance filing within 10 days. CSID and Water Division should review this material and, if appropriate, request further information from Cal-Am.

In the next GRC, Cal-Am should make a more comprehensive showing on its service quality for the Felton district. This showing should include additional data collected through better monitoring and reporting. Therefore, we direct Cal-Am to develop (1) a new quarterly report that provides California specific statistics, by district, from the national call center and that breaks out type of calls and final disposition of all complaints, and (2) a new quarterly report on all

complaints received at district and regional levels and their final disposition. These reports should be developed within 60 days and filed on a quarterly basis with CSID and Water Division, and served on all parties.

We do not find the evidence supports a finding of overall poor service quality or an adjustment to Cal-Am's ROE. As the Felton community and Cal-Am proceed with negotiations for a municipal water system, Cal-Am should be extra vigilant in monitoring its Felton customer service quality and taking affirmative steps to establish better working relations with the community.

### **B. Action on Proposed Felton District Settlement**

We do not find the proposed settlement as a whole reasonable in light of the whole record, consistent with the law, and in the public interest. Specifically, we find changes should be made to the allowed Highway 9 costs and other A&G expenses, and an adjustment made for lobbying activity to O&M, payroll, other A&G and authorized GO expenses. In addition, we require additional tracking and reporting of customer complaints at both the national call center and the regional offices. These issues are substantial and cause us to reject the settlement as a whole. Because the settlement was contested, we have a sufficient record to adopt different outcomes than those proposed in the settlement.

On all other issues except those specified above, we find that the resolution proposed by Cal-Am and DRA is reasonable and supported by the record; we individually adopt these proposals.

### **C. Issues Not Addressed in Proposed Settlement**

#### **1. Rate design**

In Special Request 1, Cal-Am proposes to eliminate the existing conservation discount program because it is difficult to administer and instead adopt a new rate design with an increasing three-block structure. Cal-Am

testifies that the current rate structure is unusual and was likely chosen for computational convenience but needs to be replaced because it delivers inconsistent and often wrong price signals. Although the Felton district does not face the same water supply issues as the Monterey district, adopting a rate design that better promotes conservation is desirable.

DRA opposes Cal-Am's proposal, testifying that the current rate design better provides customers with incentives to curb usage and penalizes high usage customers. The current rate design provides Felton customers the following conservation discounts:

<u>Bimonthly usage</u>	<u>Discount (applied to total bill)</u>
10 units or less	20%
Up to 20 units	15%
Up to 30 units	10% <sup>90</sup>

DRA shows that under Cal-Am's proposal, the average customer could double its usage and not be penalized with higher rates. In seeking to adopt a rate design that would penalize high usage customers, Cal-Am is eliminating the current incentive for the average customers to conserve water. In addition, DRA cites Cal-Am's testimony to establish that the existing rate design does penalize higher use customers.<sup>91</sup> In a district that is experiencing very high rate increases, the existing conservation discount provides customers with a tool to help manage their water usage.

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<sup>90</sup> Transcript at 175 and 176. Cal-Am also testifies that the average Felton customer uses between 16 and 18 units on a bimonthly basis and thus, on average, receives a 15% discount.

<sup>91</sup> Transcript at 179.

Felton FLOW does not take a position on this issue. At the PPHs, customers who testified on rate design strongly opposed Cal-Am's proposal, citing complexity and the loss of a conservation discount.

We find Cal-Am has not shown that its rate design proposal would be equitable and better promote conservation. The current rate design is accepted by the community and has an incentive for conservation by the average customer. Therefore, we do not adopt Special Request 1.

## **2. Low-Income Program**

In its Special Request 2, Cal-Am requests that a low-income tariff be adopted in the Felton district and proposes a program that would provide customers whose household income is at or below 175% of the federal poverty level an elimination of the monthly service fee or \$7.50, whichever is lower. Cal-Am asserts that this proposal would provide approximately the same benefit as its PAR program in Monterey which eliminates the service fee.

DRA testifies it supports establishing a low-income program for Felton, especially in light of the large rate increases customers are experiencing, but opposes Cal-Am's proposal because it is insufficient. Instead, DRA recommends the Commission adopt a low-income program for Felton that is similar to the program we recently adopted for San Gabriel Water Company's Los Angeles district in D.05-05-015. This program provides customers with a 50% discount on the monthly service charge and does not limit the benefit to any specific amount. DRA's proposal is presented in Exhibit 90, Chapter 13.

DRA states that the monthly service charge in Felton at the time it issued its report was \$16.40. Since then, the Commission in D.05-09-004 ordered the rate increase adopted but deferred in D.04-05-023 to be implemented. This raised the monthly service charge to \$28.16. If the Commission adopts the proposed

settlement in this proceeding, the monthly service charge will rise to approximately \$39.00. Felton customers also pay an \$11.50 surcharge for their filter plant, financed through SDWBA bonds, and will pay a monthly fee to amortize the accumulated balance in the deferred rate balancing account ordered in D.04-05-023. Therefore, Felton customers will be paying over \$50 a month before even using any water, and low-income customers under Cal-Am's proposal would be paying over \$42.50 a month.

We find that DRA's low income program proposal is preferable to Cal-Am's proposal because it is modeled on the San Gabriel program we earlier adopted and it provides a more meaningful level of relief for customers. Therefore, we deny Cal-Am's Special Request 2 and adopt DRA's proposal.

### **3. On-going Municipalization Efforts**

In its opening brief, Felton FLOW requests the Commission acknowledge the overwhelming support of the local community for the public acquisition of the Felton district and facilitate an expeditious transition to public ownership. It cites to the 74.8% of voters who approved Measure W and urges the Commission to facilitate a fair, equitable, orderly, and efficient transition to public ownership of the water facilities serving Felton. Specifically, it urges the Commission to either issue an order similar to the order requiring Cal-Am to divest the Felton district to a public agency with access to lower cost tax exempt financing, as it did in D.02-12-068 for Montara district, or in the alternative, to continue this proceeding for further consideration of alternatives for addressing the concerns of Felton district residents regarding rate shock, service, and future ownership of the Felton district facilities.

In its reply brief, Cal-Am asserts that it would be highly improper for the Commission to become involved in the municipalization efforts. It sees the

process as still early and moving to future condemnation. Further, it states the Commission does not have the authority to approve the actual condemnation of public utility property. Finally, it distinguishes the situation of the Montara district divestiture ordered in D.02-12-068 because the Commission found that (1) the Montara District had unique and persistent problems with water quality, service, capacity, and rates; (2) the Montara Sanitary District was in a position to obtain low-cost tax-exempt financing to make long-overdue capital improvements; (3) Montara District voters approved a bond measure to acquire the Montara District facilities over 12 months before D.02-12-068 was issued; and (4) the Montara Sanitary District had filed a condemnation action in Superior Court. Cal-Am asserts that none of these facts applies to the Felton District. (D.02-12-068, *supra*, 2002 Cal. PUC LEXIS 909, \*69-\*71.)

We recognize the customer dissatisfaction that exists in the Felton district and in this proceeding we have directly addressed cost of service, service quality, and rate shock. In considering Felton FLOW's request that the Commission facilitate negotiations between the parties on municipalization, we do not find a record here sufficient to order Cal-Am to divest the district. However, the Commission's policy is to strongly encourage parties to pursue alternative dispute resolution (ADR), either as a substitute or in tandem with formal litigation, and we encourage the parties to do so here. The Commission has trained ALJs and they are available, if both Cal-Am and Santa Cruz County request our assistance. Our ADR program is set forth in ALJ Resolution 185, issued August 25, 2005.

As part of the partial settlement, Cal-Am, at the request of DRA and Felton FLOW, agreed not to pursue any further work on the main at Bull Creek if Measure W passed. Felton FLOW has asked that we also prohibit Cal-Am from

undertaking any additional projects that are not essential. Cal-Am responds that the Commission should not hamstring it from exercising its best judgment on how to maintain and operate its water system.

While Cal-Am asserts that public acquisition may never materialize or be long delayed, we nevertheless recognize the process has started with passage of Measure W. In formal condemnation proceedings, a public utility is often paid more than the cost of its rate base facilities. Therefore, we should be vigilant in overseeing future plant investment in the Felton district. We direct that Cal-Am file by advice letter for review and approval of any additional projects.

#### **4. Rate Shock**

Felton FLOW requests the Commission recognize the significant rate shock that would result in Felton if the proposed settlement is adopted and authorize measures to mitigate rate shock. In D.05-09-004, we authorized implementation of the rate increase adopted but deferred in D.04-05-023 but we directed that the undercollection in the balancing account related to D.04-05-023 be amortized over six years. We also said that we would consider in this proceeding “any proposals the parties may have advanced for tempering the effects of whatever rate increase is approved there.”<sup>92</sup> Felton FLOW asserts that not only would a large rate increase here compound the recent large rate increase of D.05-09-004, but these increases are on top of already high rates in Felton. Therefore, the Commission should take significant remedial action. The specific measures Felton FLOW recommends are for the Commission to adopt its proposed rate adjustments in this proceeding and to order Cal-Am to divest the Felton district to a public entity.

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<sup>92</sup> Id., mimeo. at 33-34.

Cal-Am states that the rate increase for the Felton district contained in the proposed settlement is approximately 32%, as shown on page 6 of the settlement. It states that this increase is reasonable in light of the costs of providing service in Felton, and there is no need for the Commission to make any further special provisions to address alleged rate shock. Further, while D.05-09-004 results in a large additional recent rate increase, this is caused in large part by long intervals between authorized increases, not by wildly excessive rate awards.<sup>93</sup> In support of its position, Cal-Am cites to a 62.8% increase authorized by the Commission for Apple Valley Ranchos Water Company in D.90-02-045.

DRA joins Felton FLOW in requesting the Commission address rate shock and recommends that the Commission not implement the full rate increase here immediately. Instead, it recommends we apply our established policy of limiting rate increases to 50% of present rates in the first year after a decision increasing rates.<sup>94</sup>

We have adopted several of Felton FLOW's adjustments, but the rate increase for this GRC is still substantial. Combined with the recent increase from D.05-09-044, we are concerned with rate shock and impose a limit of 50% in the first 12 months. This limit should be calculated to include the rate increase effect of amortization of D.05-09-044's balancing account and also the deferred balance in this case from interim rates.

## **VI. General Office Rate Case**

Cal-Am's corporate GO expenses are typically presented for our examination every three years with its Monterey GRC. The settlement sets the

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<sup>93</sup> See D.05-09-004, mimeo. at 31.

<sup>94</sup> See Re Thomas H. and Peggy A. Porter dba Grizzly Park Water Company, 18 CPUC 2d 21.

total dollars (including costs of the Western Region General Office of AWW and costs associated with the corporate office of Cal-Am) and allocation factors for Cal-Am's nine California districts over this GRC period.<sup>95</sup> The settlement also includes the synergy savings analysis for amortization of the Citizens' acquisition premium and the calculation of RWE savings. A major change in this proceeding is to include outside services, previously billed separately to each district, in GO expenses.

Felton FLOW contests this settlement, opposing any increase in GO corporate expenses and any amortization of the Citizens' acquisition premium on the grounds that RWE, AWW and Cal-Am have not met the cost savings commitments they made when they sought approval of the Citizens acquisition and RWE merger. Specifically, Felton FLOW cites to the increase of overall expenses at a rate greater than general inflation, the inclusion of lobbying expenses, the lack of substantial RWE net benefits, and the "impenetrable model" that Cal-Am and DRA claim demonstrates synergy savings from the Citizens' acquisition.

### **A. Salaries**

In 2004, Cal-Am reorganized its Western Region office, moving employees to the office from subsidiaries, primarily from Arizona and California. This resulted in the number of employees growing from 24 in 2004 to 47 in 2006. In its report, DRA found this substantial increase questionable and recommended Cal-Am's 2006 request of \$5,287,600 be reduced to \$4,387,800. DRA made this adjustment based on removing vacant positions and using estimated 2005

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<sup>95</sup> The western region includes Arizona, California, Hawaii, New Mexico, and Texas. Costs are allocated on the percentage of customers in each district. The California districts represent 53.6% of the total.

figures. It testifies that Cal-Am provided little justification for the increase beyond the generic mention of “further expand economies of scale and facilitate further consolidation of administrative, financial and customer service functions.”<sup>96</sup> DRA also testifies that comparison to prior years is confusing as some of these costs were previously shown in A&G expenses of individual districts.

In the settlement, the parties agree to \$5,122,600, stating this compromise is based on Cal-Am agreeing to remove two positions and demonstrating to DRA that most of the increased salaries are related to non-regulated and capitalized activities that have been properly removed from the regulated charges. We do not find that the parties have sufficiently explained and justified the level of rate increase requested here.

Therefore, we adopt DRA’s original recommendation, with a corresponding reduction in the amount allocated to Monterey and Felton. In upcoming GRC proceedings for other districts, Cal-Am can request the full amount be allocated to a district if it makes a showing that fully supports the increase.

We also find that the amount allocated to Felton district should be reduced by 5% to reflect the lobbying activities testified to by Kevin Tilden in preparing legislation related to changes in California’s condemnation law.

## **B. Employee Expense**

This category is directly related to salaries discussed above and contains the same justification. Based on our discussion above, and for the same reasons, we should adopt here DRA’s original recommendation of \$397,400. In upcoming

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<sup>96</sup> Ex. 92, page 2-6, referencing Exhibit 1, Henderson, page 5.

GRCs for other districts, Cal-Am can request the district's allocated amount be based on the \$636,000 settlement figure if it can make a showing that the expenses are justified. Again, the amount allocated to Felton district should be reduced by 5% to reflect an adjustment for lobbying activities.

### **C. Outside Services**

The parties agree that the amounts for outside services that Cal-Am previously included in the A&G expense for each district should be shown in GO. This increases the expenses in this category from \$0 to \$5,532,600.

The settlement adopts the amount proposed by DRA in its testimony. DRA's report reflects that it made adjustments to amounts originally booked by Cal-Am in each district's A&G expenses and adjusted these expenses downward to reflect an inflation-based increase for the years 2001 to 2006.<sup>97</sup>

Based on DRA's testimony we find this amount should be used for the allocation to Monterey and Felton. However, in upcoming GRCs for each California district, Cal-Am should make a showing of the reasonableness of total A&G, O&M, and GO expenses that are higher than the rate of inflation.

### **D. Amortization of Citizens' Acquisition Premium**

Cal-Am requests recovery of the Citizens' acquisition premium in its Monterey application at \$968,600 per year and in its Felton application at \$57,200 per year. In both applications, its request is supported with only this statement:

Decision 01-09-057 approved Cal-Am's purchase of Citizens assets and authorized the recovery of the acquisition premium. The portion of the acquisition premium included for the Monterey/Felton District was based on the determination of the amount and allocation derived in Applications 04-04-040

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<sup>97</sup> Ex. 92, page 2-13.

and 04-04-041 for the Sacramento and Larkfield District's general rate case filings, respectively.<sup>98</sup>

In its June 30, 2005 report, DRA recommends that Cal-Am's request for recovery of the acquisition premium be disallowed as savings resulting from synergies of the Cal-Am/Citizens merger have not been proven. DRA bases this recommendation on its analysis of forecasted GO expenses, which it asserts have gone up at a rate greater than inflation on a per customer basis since the acquisition.<sup>99</sup>

On July 12, 2005, DRA served an errata report that deleted its earlier recommendation. DRA stated that determination of the amount to be recovered was part of the settlement in Applications 04-04-040 and 04-04-041 and that DRA accepts Cal-Am's estimate subject to revision if necessary upon the Commission's approval of the settlement.<sup>100</sup>

In D.01-09-057, the Commission approved Cal-Am's acquisition of Citizens' California water districts. The decision also adopts a methodology whereby Cal-Am can amortize over 40 years the premium over book value it paid to acquire the Citizens' assets to the extent that Cal-Am demonstrates synergy savings each year from the acquisition that at least equal the amortization amount. The synergy savings/premium amortization methodology adopted by the Commission is set forth in Finding of Fact 9 as follows:

- a. CalAm would book the acquisition premium for California regulated assets as an acquisition adjustment to be amortized mortgage-style over

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<sup>98</sup> For Monterey, see Exhibit 57 Chapter 6 and for Felton, see Ex. 63, Chapter 6.

<sup>99</sup> Ex. 92, page 1-2.

<sup>100</sup> Ex. 93, Page 1-2.

- 40 years beginning in 2002. This mortgage-style amortization represents the return of and on the acquisition adjustment.
- b. CalAm would recover in rates all proven synergies savings in 2002, 2003, and 2004.
  - c. Beginning in 2005, CalAm would recover in rates the proven synergies savings up to the amortization amount, plus 10% of any proven synergies savings in excess of the amortization amount, the other 90% to remain with ratepayers.
  - d. If proven synergies savings were insufficient to recover the full amortization amount in any year beginning in 2002, CalAm would suffer the shortfall and no part of the shortfall would be carried forward to a subsequent year.
  - e. Ratepayers would receive all synergies savings after the acquisition adjustment has been amortized; *i.e.*, beginning in 2042 rates would return to being based on cost of service.
  - f. There would be no general rate case stayout period going forward.
  - g. The GRC filing schedule would be:
    - (1) Citizens Division GRC filed in January, 2002 for rates effective for test years 2003 and 2004.
    - (2) Citizens Division GRC filed in January, 2004 for rates effective 2005.
    - (3) Monterey Division and GO GRCs filed in January, 2002 for test years 2003 and 2004 and attrition year 2005.
    - (4) Los Angeles and Village Division GRCs filed in January, 2003 for rates effective 2004.
    - (5) Coronado Division GRC filed in January, 2004 for rates effective in 2005.
  - h. CalAm would prove its claimed synergies savings in the 2002 GRC filing, and the Commission would review them again in the 2004 GRC filing to ensure CalAm had achieved and maintained them. Thereafter, they would be carried forward using agreed-upon escalation methods and factors. CalAm would carry the burden of proving that any new or increased GRC expenses (excluding those due to inflation and customer

growth) in future years were not erosions of earlier-estimated synergies.

- i. Liability for historic advances would remain with Citizens and CalAm would not record historic advances and contributions on its books. To ease the transitional effect on rates, CalAm would initially treat those advances and contributions as a rate base deduction for ratemaking purposes in the Citizens Division, to be ratably restored over 20 years. (D.01-09-057, mimeo at pages 67-8. See also Ordering Paragraph 3, mimeo at 73.)

In the recent Sacramento/Larkfield GRCs, A.04-04-040/041, Cal-Am did present a table of synergy savings and DRA reviewed these and issued its report. The report proposed some adjustments, which the parties later resolved in a proposed settlement. In underlying testimony, both Cal-Am and DRA agreed that the premium for each year should be allocated to each district based on total customers, making the historic Cal-Am districts responsible for approximately 50% and the former Citizens districts 50%.

In D.05-09-020, the Commission adopted the proposed settlement, attached as Appendix A to that decision. In both the underlying settlement and the decision, the language clearly states that the agreement should not be construed as a precedent or statement of policy for current or future proceedings. The settlement also required that in future proceedings for the Sacramento and Larkfield districts, (1) Cal-Am will provide DRA a table similar to the one attached as Exhibit B to the settlement that shows material changes are not occurring in the revenue requirement of and on the premium or in the total synergies, and (2) Cal-Am will file this table together with any additional requested information.

We find that Cal-Am's reliance on the last GRC proceeding to fully support its showing here is weak. The settlement reached was non-precedential

and the decision does not discuss changing to a total customer allocation methodology. Cal-Am does not include a table or any other supporting documentation in its current filing.

Of additional concern, Cal-Am does not address here the requirement of D.01-09-057 to show that any new or increased GRC expenses are not erosions of earlier estimated synergies. We have, in our review of O&M, A&G, and GO expenses, looked at this requirement and made adjustments where Cal-Am did not meet its burden of proof. Based on this review and the adjustments made, we find it reasonable to authorize the amortization expense for Monterey and Felton for this GRC period. However, we direct that the 2009 GO audit include a review of the synergy methodology and that Cal-Am make a full showing in support of its request to amortize the premium in each intervening GRC application.

In the Monterey settlement discussion, we expressed our concern with Cal-Am and DRA continuing to use separate capital structures for the historic Cal-Am districts and the former Citizens districts. We find this may have been appropriate for an initial period after the acquisition, but this is no longer reasonable after five years have passed, the RWE merger has occurred, and another ownership change is pending. We find in this decision that use of separate capital structures is not reasonable as it results in Monterey customers paying higher capital carrying costs at a time they face extraordinary capital projects. Thus, we will examine this issue in each upcoming Cal-Am GRC and direct it be included in the synergy savings/amortization methodology review done as a part of the 2009 GO GRC audit.

**E. Action on Proposed GO Settlement**

We find that while the majority of issues are settled in a manner that meets our standard of review for settlements, there are several issues where Cal-Am and DRA do not reach a resolution we should approve. Specifically, we reduce the proposed level of GO salaries and employee expenses allocated to Monterey and Felton customers, and require a showing in each upcoming GRC in support of GO expense levels and the amortization of the Citizens' acquisition premium. In addition, we expand the scope of the 2009 outside audit proposed by Cal-Am and DRA to include a full review of the methodology used to allocate the Citizens' acquisition premium.<sup>101</sup> While expressing concern, we do adopt for Monterey and Felton the proposed amortization amounts for the Citizens' acquisition premium.

We find that the GO expenses other than those discussed above and the rate base allocations contained in the settlement are individually reasonable and based on the record and we adopt them. Finally, we adopt RWE net savings benefits for Monterey of \$370,400 for 2006, \$555,299 for 2007 and \$626,454 for 2008, and for Felton net savings of \$14,981 in 2006, \$20,852 in 2007, and \$22,170 in 2008.

**VII. True-Up of Interim Rates Adopted in D.05-12-024**

In D.05-12-024, we found it in the public interest to grant interim rate relief to Cal-Am for the Monterey and Felton districts. Consistent with Section 455.2,

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<sup>101</sup> Cal-Am and DRA agree that DRA will retain an outside audit firm to review Cal-Am's GO operations and cost allocations in connection with the 2009 GO GRC. The scope they propose is to review if GO allocations to the districts are reasonable and in accordance with applicable Commission decisions, rules, and policies regarding cost allocation. In addition, A&G expenses that were previously part of GO allocations will also be audited, and a review of Cal-Am's compliance with the Commission's affiliate transaction rules will be conducted.

the interim rate increase is based on the rate of inflation as compared to existing rates for each district, is subject to refund, and will be adjusted upward or downward, back to January 1, 2006, based on the final rates adopted by the Commission in this decision.

Based on our decision today, there will be a surcharge for the period since January 1, 2006. Cal-Am should calculate this surcharge amount based on the actual loss or gain in each district's revenue, determined by applying the rate differential to the actual quantities of water sales and the actual number of customers.

For the Monterey district, Cal-Am should recover this surcharge over the following 12 months. For the Felton district, Cal-Am should recover the surcharge over a period consistent with our 50% rate cap. For both districts, Cal-Am should earn interest at the 90-day commercial paper rate on the surcharge balance.

#### **VIII. Preparation of Rate Tables and Comments on Proposed Decision**

The draft of the principal hearing officer's proposed decision contained a complete determination of all known issues but lacked attached rate tables. The draft decision was circulated together with a ruling directing Cal-Am and DRA to provide assistance to the Commission's Water Division in preparing the figures and appendices needed to complete the proposed decision. Other parties were permitted, but not required, to participate.

Water Division forwarded its figures and appendices to the assigned ALJ, to be reviewed for consistency with the draft proposed decision. After completion of internal review, the proposed decision was filed and made available for comments as required by Section 311(d) and Rule 77.1.

**IX. Assignment of Proceeding**

John A. Bohn is the Assigned Commissioner and Christine M. Walwyn is the assigned ALJ in this proceeding.

**Findings of Fact**

1. This decision resolves Cal-Am's GRC applications for the Monterey and Felton districts and the corporate GO rate case.

2. On October 21, 2005, Cal-Am and DRA filed partial settlements for the Monterey district, the Felton district, and corporate GO expenses. MPWMD filed a timely protest to the Monterey settlement and Felton FLOW filed a timely protest to all three partial settlements.

3. The testimony and hearing record provide a comprehensive record for consideration of the settlement.

**Monterey District**

4. Monterey district customers face extraordinary capital investment projects in this GRC and beyond. Therefore, the Commission should ensure that these customers are given the benefit of Cal-Am's least expensive capital structure, cost of debt, and return on equity.

5. A capital structure of 63% debt/ 37% equity for the Monterey district is reasonable and in the public interest.

6. A cost of debt of 6.37% for Monterey district for the three GRC years is reasonable and in the public interest.

7. A leverage adjustment for Cal-Am's return on equity is not warranted.

8. A return on equity of 10.10% for Monterey for the GRC period is reasonable based on the record and is fair because the return is commensurate with returns on investments in comparable companies and is sufficient to (a)

assure confidence in the financial integrity of Cal-Am, (b) maintain its credit, and (c) attract necessary capital.

9. In the next Monterey GRC, Cal-Am should discuss in its direct testimony the measures it has taken to ensure Monterey customers are given the benefit of the least expensive capital structure and cost of debt and equity.

10. For ratemaking purposes only, unaccounted for water percentages of 8.5% for the main system, 9.0% for the Ambler/Bishop subsystems, and 10.0% for the Hidden Hills/Ryan subsystems are reasonable.

11. An amount of \$120,000 for meter replacements over the GRC period is reasonable. The \$37,200 proposed in the settlement is not reasonable.

12. An amount of \$4.2 million for repair and replacement of Carmel Valley main segments 4, 5, 6, and 10 is reasonable.

13. Cal-Am should provide in its next Monterey GRC application a specific analysis of leakage in the Carmel Valley main system.

14. An expenditure of \$750,000 is reasonable for improvements to the Bishop subsystem treatment plant as the improvements are necessary to maintain water quality. The advice letter process should be used due to the uncertain timing of the project.

15. We should direct Cal-Am to provide in its next GRC filing a full breakout of (a) all capital improvement projects undertaken in each of the four Monterey district subsystems since SWRCB Order 95-10, and (b) a breakout of estimated costs for additional capital projects planned over the coming ten years.

16. The establishment of a WRAM account to track emergency rate overcollections is reasonable provided that no SWRCB fines are paid from this account. The refund mechanism adopted in D.05-03-012 is reasonable because it

allows overcollections to be quickly returned and directly rewards customers who avoid the emergency rates through prudent water usage.

17. Establishment of a memorandum account to track compliance with ESA requirements is reasonable. ESA compliance costs associated with the San Clemente Dam retrofit should be tracked in a separate memorandum account with all other San Clemente Dam retrofit costs.

18. A special conservation surcharge not to exceed \$300,000 from Cal-Am to MPWMD, with special reporting requirements, is reasonable. Cal-Am should enter into a formal agreement with MPWMD, as detailed in this decision.

19. All current balancing accounts should be refunded in accordance with standard Commission policies.

20. Cal-Am should provide in its next Monterey GRC application a comprehensive showing of any changes in O&M expenses, payroll expenses other than pension payments, other A&G expenses, and allocated GO expenses that are greater than the rate of inflation.

21. To address customer service concerns in the Monterey district, Cal-Am should develop (a) a new quarterly report that provides California-specific statistics, by district, from the national call center and that breaks out type of calls and final disposition of all complaints; and (b) a new quarterly report on all complaints received at district and regional levels and their final disposition. These reports should be developed within 60 days of this decision and routinely filed on a quarterly basis with the Commission's Consumer Service and Information Division and Water Division, with service on all parties to this proceeding.

22. We should not grant Cal-Am's request to discontinue the RWE savings memorandum account prior to the time specified in D.02-12-068 because Monterey customers are only beginning to receive significant savings in 2006.

23. The step rate increases for Monterey should be based on the methodology proposed by Cal-Am and DRA with a modification to reflect the actual capital structure adopted in this decision.

24. We do not find reasonable the Monterey proposed settlement's treatment of capital structure, cost of debt, meter replacement, early discontinuance of tracking RWE savings, and the allocated amount of corporate GO expenses. We find the outcomes for all other issues covered in the settlement to be individually reasonable and based on the record.

25. The San Clemente Dam retrofit is a lengthy and uncertain project. All costs related to the project, including ESA compliance costs, should be tracked in a memorandum account until the Commission has the opportunity to fully review the completed project for reasonableness. The memorandum account should have a cost cap of \$9,379,525 for 2004, \$1,321,590 for 2005, \$1,863,825 for 2006, and \$11,433,000 for 2007 and accrue interest at the 90 day commercial paper rate.

26. The Carmel River Dam project was planned during a period of dramatic and protracted uncertainty and unusually high risk for Cal-Am.

27. We find that operating under Order 95-10, and later the additional requirements of the Plan B legislation, has meant Cal-Am's management had less control than a utility normally has over the timing of the Carmel River Dam project.

28. Based on the requirement of Order 95-10 for Cal-Am to always be actively pursuing a water supply project, the initial cost-effectiveness of the project, the

environmental approvals through 1999, and the support of key public agencies for its actions, we find Cal-Am acted reasonably in initially pursuing the Carmel River Dam project and then in waiting until it had approval for an alternative project, the Coastal Water Project, to cancel the project.

29. We should not authorize Cal-Am to book ESA fines into a memorandum account as allowing recovery of fines generally is contrary to Commission policy, and the record shows Cal-Am's management has reasonable means to avoid ESA fines.

30. We should not authorize Cal-Am to book SWRCB fines into a memorandum account. The record shows that Cal-Am now has the conservation programs, emergency rate measures, and environmental compliance programs to operate its water supply system in a manner to avoid fines. Our earlier decisions to allow recovery of SWRCB fines were a deviation from one general policy on recovery of fines, and were a temporary measure, expected to be of brief duration, until effective rationing plans could be implemented by Cal-Am and MPWMD.

31. We should retain the existing rate design for Monterey with one modification: in residential rates for main system customers we eliminate the per capita allocation in the third through fifth blocks to promote more conservation of outdoor water use.

32. Cal-Am should undertake to complete all Monterey district commercial water audits before next summer.

### **Felton District**

33. A capital structure of 63% debt/ 37% equity, a cost of debt of 6.37% and a return on equity of 9.95% for the Felton district for the three year GRC period is reasonable.

34. The record does not support lowering Cal-Am's return on equity due to poor service quality.

35. To address customer service concerns in the Felton district, Cal-Am should develop (a) a new quarterly report that provides California specific statistics, by district, from the national call center and that breaks out type of calls and final disposition of all complaints, and (b) a new quarterly report on all complaints received at district and regional levels and their final disposition. These reports should be developed within 60 days of this decision and routinely filed on a quarterly basis with the Commission's Consumer Service and Information Division and Water Division, and served on all parties to this proceeding.

36. The record establishes that Cal-Am's filing includes some political and lobbying activities by its employees. It reasonable to make a 5% reduction to operating and maintenance expenses, general and administrative expenses and allocated GO expenses to adjust for the inclusion of this activity in customer rates.

37. DRA's initial recommendation of \$91,300 for administrative and general expenses other than payroll and pensions is reasonable.

38. A \$50,000 reduction to Highway 9 project costs is reasonable in order to reflect the construction deficiencies cited by the California Department of Transportation and Cal-Am's cost to remedy the problem.

39. We do not find reasonable the Felton proposed settlement's treatment of Highway 9 project costs, administrative and general expenses, allocated GO expenses, and inclusion of political and lobbying activities by employees. In addition, we find additional tracking and reporting of customer complaints and a comprehensive showing of any changes greater than the rate of inflation for

O&M expenses, payroll expenses, and other A&G expenses is required. We find the outcomes for all other issues covered in the settlement to be individually reasonable and based on the record.

40. We should retain the existing rate design for Felton.

41. DRA's proposed low-income program is reasonable and meets our policy objectives.

42. We should address the issue of rate shock for Felton customers by applying our policy of limiting rate increases to 50% of present rates in the first year after a decision increasing rates. We should calculate this to include the rate increase effects of D.05-09-044.

43. Cal-Am should provide in its next Felton GRC application a comprehensive showing of any changes in O&M expenses, payroll expenses other than pension payments, other A&G expenses, and allocated GO expenses that are greater than the rate of inflation.

#### **GO Rate Case**

44. Cal-Am and DRA do not sufficiently explain and justify their settlement on salaries. We find DRA's original recommendation of \$4,387,800 is justified by the record and should be adopted.

45. Cal-Am and DRA do not sufficiently explain and justify their settlement on employee expenses. We find DRA's original recommendation of \$397,400 is justified by the record and should be adopted.

46. In upcoming GRCs, if Cal-Am makes a showing in its application that fully supports the settlement's salary and employee expenses, we will consider allocating that district GO expenses based on the settlement amounts.

47. In the 2009 outside audit of GO expenses, Cal-Am should include a comprehensive review of its Citizens' synergy savings methodology.

48. In upcoming GRCs for California districts prior to 2009, Cal-Am should make a showing to support its request to amortize the Citizens' acquisition premium.

49. A more comprehensive showing by Cal-Am is needed regarding the total level of GO expenses and the use of the synergy methodology. We find the outcomes for all other issues covered in the settlement, such as GO rate base allocation and RWE net savings, are individually reasonable and supported in the record.

50. The surcharge to true-up the interim rates authorized in D.05-12-024 for the Monterey and Felton districts should be based on the actual loss or gain in Monterey's revenue since January 1, 2006, determined by applying the rate differential to the actual quantities of water sales and the actual number of customers. For the Monterey district, the interim rate surcharge should be recovered over the following 12 months. For the Felton district, Cal-Am should recover the surcharge over a period consistent with the 50% rate cap adopted here. For both districts, Cal-Am should earn interest at the 90-day commercial paper rate on the surcharge balance.

### **Conclusions of Law**

1. The standard of review for the settlements is set forth in Rule 51.1(e) of our Rules of Practice and Procedure. This rule provides, in general, that, prior to approval, the Commission must find a settlement "reasonable in light of the whole record, consistent with the law, and in the public interest."

2. The partial settlement for the Monterey district filed by Cal-Am and DRA should be rejected because it does not meet our standard of review. However, parts of the settlement are reasonable and supported by the record, and should be adopted as set forth in the foregoing opinion and findings.

3. Consistent with the treatment we authorized for Cal-Am's Coastal Water Project in D.03-09-002, the San Clemente Dam retrofit project costs should be removed from ratebase and placed in a memorandum account for later reasonableness review.

4. Cal-Am has shown that the Carmel River Dam is an abandoned project eligible to be considered for rate recovery under the standards established in D.84-05-100, and later cited by the Commission in D.89-12-057 and D.96-09-039.

5. Recovery of \$3,646,452 in project costs should be granted for the abandoned Carmel River Dam project. These costs should be placed in an interest-free balancing account and collected through a meter surcharge over the next six years.

6. The Felton district and GO settlements filed by Cal-Am and DRA should be rejected because they do not meet our standard of review. However, parts of the settlements are reasonable and supported by the record, and should be adopted as set forth in the foregoing opinion and findings.

7. We should adopt the rate tables and tariff sheets attached in the appendices to this decision for the Monterey and Felton districts and the GO rate case.

8. Today's decision should be made effective immediately.

## **O R D E R**

**IT IS ORDERED** that:

1. The Monterey district rate tables attached as appendices are adopted.
2. The Felton district rate tables attached as appendices are adopted.
3. The corporate general office rate tables attached as appendices are adopted.

4. Cal-Am is authorized to file in accordance with General Order 96, and to make effective on not less than five days' notice, the revised tariff schedules for Monterey and Felton that are attached as appendices to this order. The revised tariff schedules shall include all special requests adopted in this decision. The revised tariff schedules shall apply to service rendered on and after their effective date.

5. Cal-Am is authorized to file advice letters seeking Commission authorization for rate offsets in the Monterey district for the following capital projects when each has been completed and placed in service, no earlier than the year indicated and at costs not to exceed those indicated:

- a. Forest Lake Tank #3, test year 2007, maximum cost of \$4,575,000.
- b. Segunda Tank, test year 2006, maximum cost of \$2,150,000.
- c. Arsenic treatment project, test year 2006, maximum cost of \$3,530,000.

6. Cal-Am should file conforming language for the Monterey district step rate increases by advice letter compliance filing within 5 days of this decision.

7. Consistent with the step rate increase language adopted for the Monterey and Felton districts, Cal-Am is authorized on or after the dates specified to file advice letters in conformance with General Order 96, with appropriate supporting workpapers, requesting the step rate increases. In accordance with the Commission's policy for approving step and attrition increases, if Cal Am's earnings, based on the recorded test specified in the appendices, exceed its authorized return, the requested step or attrition increase shall be reduced to offset the earnings in excess of the authorized return in this proceeding.

8. The San Clemente Dam retrofit project costs shall be removed from ratebase and placed in a memorandum account for later reasonableness review.

9. All Carmel River Dam project costs shall be removed from ratebase, and \$3,646,452 in project costs shall be placed in an interest-free balancing account and collected through a meter surcharge over the next six years

10. Cal-Am shall develop (a) a new quarterly report that provides California-specific statistics, by district, from the national call center and that breaks out type of calls and final disposition of all complaints; and (b) a new quarterly report on all complaints received at district and regional levels and their final disposition. These reports shall be developed within 60 days of this decision and routinely filed on a quarterly basis with the Commission's Consumer Service and Information Division and Water Division, and served on all parties to this proceeding.

11. Cal-Am shall file by advice letter within 30 days a specific plan to complete all Monterey district commercial water audits prior to May 1, 2007 and, if additional funding is required, a proposed funding mechanism. The advice letter shall identify the revenues provided in customer rates since 2000 for Cal-Am to undertake these audits, and the number of audits performed each year.

12. Cal-Am shall separately collect the minimum ERISA pension payment for the Monterey and Felton districts through a 3% monthly surcharge on customer bills, separately reconciled for each district with an annual advice letter filing for a surcredit or surcharge, depending on the balance in the balancing account.

13. In the next Monterey and Felton GRC applications, Cal-Am shall include in its application a comprehensive showing of any changes that are greater than the rate of inflation in O&M expenses, payroll expenses other than pension payments, other A&G expenses, allocated GO expenses.

14. Cal-Am shall file by advice letter for any additional capital projects in the Felton district.

15. Cal-Am shall limit rate increases for the Felton district to 50% of rates prior to D.05-09-044 in the first year of this decision. This limit shall be calculated to include (a) the rate increase effect of amortization of the balancing account authorized D.05-09-044, and (b) the deferred balance in this case from interim rates.

16. The surcharge to true-up the interim rates authorized in D.05-12-024 for the Monterey and Felton districts shall be based on the actual loss or gain in Monterey's and Felton's revenue since January 1, 2006, determined by applying the rate differential to the actual quantities of water sales and the actual number of customers. For the Monterey district, the interim rate surcharge shall be recovered over the following 12 months. For the Felton district, Cal-Am shall recover the surcharge over a period consistent with the 50% rate cap adopted here. For both districts, Cal-Am shall earn interest at the 90-day commercial paper rate on the surcharge balance. Cal-Am shall file by advice letter within 10 days a compliance filing implementing the surcharges.

17. Cal-Am shall include in its next Monterey GRC application:

- a. A discussion of the measures it has taken to ensure Monterey customers are given the benefit of Cal-Am's least expensive capital structure, cost of debt, and cost of equity.
- b. A specific analysis of leakage in the Carmel Valley main system.
- c. A full breakout of all capital improvement projects undertaken in each of the four subsystems since SWRCB Order 95-10 and a detailed cost estimate of additional capital projects planned over the coming ten years for each subsystem.
- d. A comprehensive showing of any changes that are greater than the rate of inflation in the expense categories of O&M expenses, payroll expenses (excluding pension payments), other A&G expenses, and allocated general office expenses.

18. Exhibits 107 through 115 are entered into evidence.

19. Application 05-02-012 and Application 05-02-013 are closed.

This order is effective today.

Dated \_\_\_\_\_, at San Francisco, California.